Supreme Court, U.S.
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No. _____

In The

Supreme Court of the United States

October Term, 1998

DIAMOND MULTIMEDIA SYSTEMS, INC.,
WILLIAM J. SCHROEDER,
GARY B. FILLER AND HYUNG HWE HUH,

Petitioners,

v.

SUPERIOR COURT OF SANTA CLARA COUNTY (*PASS*),

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of The State Of California

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether Section 25400 of the California Corporations Code violates the Commerce Clause of the U.S. Constitution by imposing securities fraud liability on persons who make or disseminate statements in California, where the securities purchaser, the securities seller and the securities transaction all are outside California, thereby allowing California directly to regulate securities transactions in other states and to impose burdens on interstate commerce that are excessive in relation to the local interests served by the statute.

2. Whether Section 25400 of the California Corporations Code, which conflicts with provisions of the federal Private Securities Litigation Reform Act of 1995 and undermines the purposes of Congress in enacting the Reform Act, is therefore impliedly preempted.

STATEMENT PURSUANT TO RULE 29.6

Diamond Multimedia Systems, Inc. does not have a parent company or subsidiaries that are not wholly owned.

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OPINIONS BELOW

The judgment of the Supreme Court of the State of California is reported at 19 Cal. 4th 1036 (1999) and is reprinted as Appendix A, at page A1. References to the Appendices bound with this Petition are styled ("A___"). The court of appeal's denial of Petitioners' writ of mandamus from the superior court's Order is reprinted as Appendix B, at A59. The superior court's Order overruling Petitioners' demurrer to the complaint is reprinted as Appendix C, at A60.

STATEMENT OF JURISDICTION

The Supreme Court of the State of California entered judgment on January 4, 1999 (A1-58). The jurisdiction of this Court is invoked under 28 U.S.C. § 1257. Because the constitutionality of California statutes are drawn into question, 28 U.S.C. § 2403(b) may apply.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The relevant statutory provisions, Cal. Corp. Code §§ 25400, 25500, and 15 U.S.C. §§ 78u-4 & 78u-5, are set forth in the Appendix at A63-94. The relevant constitutional provisions are the Commerce Clause, U.S. CONST. art. I, § 8, cl. 3 ("The Congress shall have the Power . . . To regulate Commerce . . . among the several States. . . . ") and the Supremacy Clause, U.S. CONST. art. VI, cl. 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and the Judges of every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.").

STATEMENT OF THE CASE

I. The Actions In The California Superior Court And The U.S. District Court

Plaintiff Joanne Pass filed this securities class action in June 1996 in the California Superior Court, alleging she had been defrauded in her purchase of stock in Diamond Multimedia Systems, Inc. Several additional plaintiffs later filed essentially identical actions which were consolidated with this action. Plaintiffs brought these actions on behalf of a class consisting of all purchasers of Diamond common stock between October 26, 1995 and June 20, 1996. The plaintiffs did not allege that they were residents of California, that they had purchased their stock in California, that they had purchased their stock from a California seller or that they had any other contacts with California.

On October 2, 1996, plaintiff Pass' attorneys, acting on behalf of a different plaintiff representing the same class, filed a parallel federal class action in the U.S. District Court for the Northern District of California, *In re Diamond Multimedia Securities Litigation*, No. 96-2644-SBA (N.D. Cal.). The allegations in the two actions are virtually identical; the only material difference between the two complaints is that the state court action alleges a claim under the Section 25400 of the California Corporations Code, while the federal action alleges a claim under Section 10(b) of the Securities Exchange Act of 1934.

The federal action is subject to the provisions of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67 (the "Reform Act"), including an automatic stay of discovery during the pendency of any motion to dismiss. 15 U.S.C. § 78u-4(b)(3). The purpose of the stay provision is to protect against abusive securities suits. Other important provisions of the Reform Act, such as its "safe harbor" for forward-looking statements and its heightened pleading standard, 15 U.S.C. §§ 78u-5(c), 78u-4(b)(1), (b)(2), serve the same purpose.

Pursuant to these Reform Act provisions, the federal action in this matter has not progressed past the pleading

stage, and no discovery has been taken. Defendants protected from discovery in federal court, however, have been subject to discovery in California courts. Indeed, one outside Diamond director, whose demurrer was *sustained* in the California court, nonetheless is subject to state court discovery, notwithstanding the Reform Act's specific effort to preclude such discovery.

II. The California Supreme Court's Decision

After Diamond's demurrer was overruled by the Superior Court (A60), and its petition for writ of mandamus was denied by the California Court of Appeal (A59), Diamond filed a petition for review in the California Supreme Court. The California Supreme Court granted Diamond's petition for review in March 1997. Reflecting the importance of the case, amicus briefs in support of Diamond were filed by the Securities Industry Association, the National Venture Capital Association, the American Electronics Association, the Washington Legal Foundation, the Allied Educational Foundation and Adobe Systems, Inc. Amicus briefs supporting the plaintiffs/respondents were filed by the International Brotherhood of Teamsters, the Service Employees International Union, the National Council of Senior Citizens, the Missouri State Employees' Retirement System, and the Pennsylvania State Employees' Retirement System. Diamond and amici Securities Industry Association, National Venture Capital Association and American Electronics Association briefed the constitutional arguments at issue here.

A. The Majority Opinion

Over a vigorous dissent, a majority of the California Supreme Court, by a 5-2 margin, gave Section 25400 broad extraterritorial effect. In giving Section 25400 this broad application, the majority noted that the scope of California's securities law has become an issue of nationwide importance, as California has become the venue of choice for plaintiffs seeking to circumvent Congress' enactment of the Reform Act. As the majority observed:

> It does appear that recent procedural changes applicable to the federal securities laws have resulted in the filing of an increased number of nationwide class action lawsuits on behalf of corporate shareholders in California courts under California law. We agree with petitioners that, as a result of the PSLRA [*i.e.*, the Reform Act], the reach of the California Corporate Securities Law is increasingly important to shareholders, corporations, and the judicial system.

19 Cal. 4th at 1045 (A10-12) (footnote omitted).

In interpreting Section 25400, the majority concluded that California's statute permits an action to be brought for *any* false or misleading statements made in California, or willfully disseminated in California, for the purpose of inducing the purchase or sale of stock. *Id.* at 1051 (A21). Anyone who purchases stock at a price affected by the false statements may state a claim under Section 25400, without regard to where the purchaser is, where the seller is, or where the transaction occurs. *Id.* at 1052, 1062-63 (A22-23, A39-42). The statute accordingly imposes liability under California law even when the purchaser of the stock, the seller of the stock, the defendants, the issuing company, the broker, the securities exchange, and the sale transaction are all in another state, provided only that a false statement is made or willfully disseminated in California. Indeed, because virtually any publicly reported statement is "disseminated" in California through the national media, California law therefore is broad enough to reach almost all transactions in the stock of publicly traded companies, even those that have nothing to do with California.

The majority's holding thus effectively transforms California's securities law into a national securities law. In holding that its interpretation of Section 25400 nonetheless does not violate the Commerce Clause, the majority contended that California has an interest in protecting fraudulent practices in California that have an effect "both in California and throughout the country." *Id.* at 1063 (A41). The majority held that

California business "depends on a national investment market" and that a broad reading of Section 25400 helps to ensure "the flow of out-of-state capital." *Id.* (A42). The majority found that the broad reach of the California statute "stimulates commerce in corporate stock" and "protect[s] the integrity of the capital market for all investors." *Id.* (A41-42). The majority's rationale thus relied on its policy judgments about the "national investment market," "commerce in corporate stock," and "the integrity of the capital market." In articulating these policy judgments, the majority recognized that its decision would affect interstate commerce and commerce in other states.

The majority rejected the dissenting justices' argument that Section 25400 had been impliedly preempted by the Reform Act. Noting that the subsequent Uniform Securities Act had expressly preempted some aspects of Section 25400, the majority found that this subsequently enacted statute reflected a "clear" Congressional intent "that, except to the extent that the 1998 act limits class actions, there is no preemption." *Id.* at 1046 n.12 (A13). The majority also rejected the argument that Section 25400 violated the Commerce Clause.

B. The Dissenting Opinion

Two justices dissented, urging that Section 25400 had never been intended "to rule the United States." *Id.* at 1065 (A46). The dissent noted that there were "actual, irresolvable conflicts" between the Reform Act and Section 25400. *Id.* at 1066 (A48). The dissent continued:

> Indeed, not a single provision of the Reform Act has a counterpart in California's Act. . . . Under California law, nothing comparable to the provisions of the Reform Act – intended both to make abusive securities strike litigation more difficult to mount and sustain, and to further the declared congressional policy of a national securities market –

> would apply to class action securities fraud suits filed in our courts.

Id. at 1069 (A52-53).

Applying the "implied conflict preemption" analysis followed by the New York Court of Appeals in *Guice v. Charles Schwab & Co., Inc.*, 89 N.Y.2d 31, 674 N.E.2d 282 (1996), *cert. denied*, 520 U.S. 1118 (1997), the dissent concluded that Section 25400 could be sustained against a Supremacy Clause challenge only by "resolutely ignor[ing] implied preemption principles." *Id.* at 1070 (A54). Indeed, the consequence of the majority's holding was the "fragmentation of the Reform Act's express national standard into as many as 50 different state standards," a result that "would wreak havoc on federal efforts to protect that market from abusive litigation practices." *Id.* at 1071 (A55).

The dissent also concluded that application of Section 25400 in this case would violate the Commerce Clause. The dissent noted that California has no legitimate interest in protecting out-of-state shareholders. The dissent, relying on this Court's Commerce Clause jurisprudence, argued that Section 25400 is invalid because California cannot apply its law to " 'commerce that takes place *wholly outside of the State's borders*, whether or not the commerce has effects within the State.' " *Id.* at 1072 (A57) (quoting *Edgar v. MITE Corp.*, 457 U.S. 624, 642-43 (1982)). The dissent concluded that the extraterritorial imposition of the California statute " 'would offend sister States and exceed the inherent limits of the State's power.' " *Id.* (quoting *Edgar*, 457 U.S. at 643). Accordingly, "[t]he same considerations that led the court to declare the Illinois statute at issue in *Edgar*, *supra*, unconstitutional under the commerce clause apply here." *Id.* (A57) (citation omitted).

REASONS FOR GRANTING THE PETITION

The California statute violates the Commerce Clause. That statute, as interpreted in the majority opinion, allows California to inject its securities law standards into securities transactions occurring wholly outside California between

non-California buyers and non-California sellers. This permits California to reach beyond its borders to create civil liability when no liability would be created by the law of the state where the transaction occurred. For example, California law would apply in a lawsuit against a New York defendant by a New York stock purchaser who buys stock of a New York company from a New York seller, with the transaction occurring in New York. The only restriction is that the plaintiff must show that one of the defendant's statements was "disseminated" in California. Given the pervasiveness of modern media, this is no restriction at all. California law would thus be applied to a New York transaction despite the lack of any significant connection to New York. The Commerce Clause forbids such broad extraterritorial application of California law.

The California statute also conflicts with the federal Reform Act. Under the Supremacy Clause, the California statute therefore is impliedly preempted. The majority's ruling allows California to create liability for interstate securities transactions in situations where Congress has determined that no liability should exist. In this case, for example, some of plaintiffs' claims are based on "forward-looking" statements, which are covered by the Reform Act's "safe harbor" provision. California law has no safe harbor. California law therefore could impose liability on Diamond for statements that are protected by the federal safe harbor, frustrating the efforts of Congress to encourage disclosure of "forward-looking" information. The majority's ruling also deprives defendants in securities litigation of the other protections against abusive litigation that Congress determined were necessary. In this case, for example, defendants are facing identical federal and state court litigation. In federal court, discovery has been stayed pursuant to the Reform Act because the complaint has not yet survived a motion to dismiss, which is governed by a heightened pleading standard. In state court, however, plaintiffs have pushed forward and have obtained discovery, which they have sought to use in their federal court case. This type of conflict undermines the purpose and intent of Congress in enacting the Reform Act. Accordingly, the

California statute is impliedly preempted. The majority's holding that there is no preemption is contrary to this Court's decisions and conflicts with the preemption analysis of the courts of at least four other states, which have preempted other state statutes in similar situations.

The issues raised in this petition will pervade securities litigation in California and elsewhere until decided by this Court. Although the recent Uniform Standards Act will bar certain future class actions under Section 25400, the issues raised here will be crucial to cases brought by individuals, institutional investors, and groups of investors, as well as class action cases involving proxy statements and tender offers. The majority's ruling in this case creates overlapping, inconsistent and conflicting state and federal regulation of securities transactions. This Court should grant review to prevent this inconsistency, to prevent the states from encroaching on the legislative judgments of other states and to prevent the states from undermining the policy judgments and objectives of Congress.

I. Section 25400 Violates The Commerce Clause

The Commerce Clause limits the power of the states to adopt legislation that affects interstate commerce or the autonomy of other states. *See*, *e.g.*, *Edgar*, 457 U.S. at 640-41 (discussing state securities laws and the Commerce Clause); *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 80 (1987) (discussing Indiana's securities laws' compliance with the Commerce Clause). This Court has articulated several independent standards for scrutinizing state statutes under the Commerce Clause. California Corporations Code Section 25400 violates two of these standards. First, Section 25400 violates the Commerce Clause's restriction on extraterritorial legislation because the statute impermissibly projects California's securities fraud legislation into the commerce of other states. Second, Section 25400 violates the Commerce Clause's balancing test because the statute imposes a burden on interstate commerce that is excessive when balanced

against the statute's benefits to the state of California. The following sections discuss these two issues in turn.

A. Section 25400 Violates The Commerce Clause By Allowing California Directly To Regulate Interstate Commerce Outside The Borders Of The State

Under the extraterritoriality analysis, the Commerce Clause precludes a state from enacting legislation that regulates interstate commerce outside the borders of the state. *Edgar*, 457 U.S. at 642; *Healy v. Beer Inst., Inc.*, 491 U.S. 324, 345-46 (1989); *Brown-Forman Distillers Corp. v. New York State Liquor Auth.*, 476 U.S. 573, 584 (1986). This is because one state may not expand its legislation to encroach on other states' sovereignty. *See Edgar*, 457 U.S. at 643; *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 571 (1996) ("[O]ne State's power to impose burdens on the interstate market . . . [is] constrained by the need to respect the interests of other States. . . . ").

Under this Court's extraterritoriality analysis, a state statute is a *per se* violation of the Commerce Clause if: (1) the statute applies to "commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State"; or (2) the statute "directly controls commerce occurring wholly outside the boundaries of a State . . . regardless of whether the statute's extraterritorial reach was intended by the legislature"; or (3) the statute's "practical effect" is to produce "inconsistent legislation arising from the projection of one state['s] regulatory regime into the jurisdiction of another State." *Healy*, 491 U.S. at 336-37 (citation omitted); *see also Edgar*, 457 U.S. at 642-43. Section 25400 improperly regulates interstate commerce in all three ways.

1. Section 25400 Regulates Commerce Outside California

A statute that applies "to commerce that takes place wholly outside the State's borders" violates the Commerce Clause "whether or not the commerce has effects within the State." *Edgar*, 457 U.S. at 642-43; *see Healy*, 491 U.S. at 336.

This is because " 'any attempt 'directly' to assert extraterritorial jurisdiction over persons or property would offend sister States and exceed the inherent limits of the State's power.' " *Edgar*, 457 U.S. at 643 (quoting *Shaffer v. Heitner*, 433 U.S. 186, 197 (1977)). The focus is the statute's territorial reach. On one hand, a state securities statute may be valid if the statute " 'appl[ies] to dispositions of securities *within* the State. . . . ' " *Edgar*, 457 U.S. at 641 (citations omitted); *CTS Corp.*, 481 U.S. at 80, 93 (Indiana statute did not violate Commerce Clause because, pursuant to internal affairs doctrine, statute applied only to corporations incorporated within Indiana). On the other hand, a state securities statute violates the Commerce Clause if the statute "regulates transactions which take place across state lines" and thus could be applied to regulate a transaction which would not affect shareholders from the regulating state. *Edgar*, 457 U.S. at 641-42; *see also Brown-Forman Distillers Corp.*, 476 U.S. at 584.

Courts in states other than California have held that a state securities statute that applies to the sale of securities outside the state or to purchasers and sellers outside the state violates the Commerce Clause. *See Arizona Corp. Comm'n v. Media Products, Inc.*, 158 Ariz. 463, 467, 763 P.2d 527 (1988) (holding Arizona securities law unconstitutional because it was an "improper interference with interstate commerce" as it regulates non-residents' purchases from an out-of-state corporation that has its principal place of business in Arizona); *Terry v. Yamashita*, 643 F. Supp. 161, 165 (D. Haw. 1986) (Hawaii's control acquisition statute, which may apply to regulate purchases even when no shareholder is a resident of Hawaii has an extraterritorial effect and "comprises a direct burden on interstate commerce and is invalid"). The holding in this case conflicts with that principle. As interpreted by the majority, Section 25400 applies to purchases and sales of securities that occur outside California between purchasers and sellers who are not California residents. Indeed, those are the facts in this case: the plaintiffs do not allege that they purchased their stock in California, that they reside in California, or that the sellers of the stock reside in California.

Under the majority's ruling, therefore, no part of the stock transaction giving rise to liability must occur in California. The only thing that needs to happen in California is that one of the defendants must make or disseminate a false statement in the state. 19 Cal. 4th at 1047, 1051 (A15, A21). Thus, Section 25400 would impose liability under California law where the purchaser, the seller, the defendants, the issuing company, both parties' brokers, the securities exchange, and the sale transaction were all in New York, provided only that one of the defendants' statements was "disseminated" in California. This would project California securities law into what is clearly a New York transaction, directly regulating New York commerce.

The majority denied that its decision would project California law into out-of-state securities transactions, stating: "That argument fails to recognize that section 25400 regulates only manipulative conduct in California. It does not purport to regulate any 'transactions' in securities which occur outside of this state. . . . " *Id.* at 1062 (A40). But this explanation is too facile. Section 25400 and its implementing section, Section 25500, create a private right of action for purchasers or sellers of stock. Without a purchase or sale, there is no cause of action. The purchaser's cause of action and the defendants' liability arise from the stock transaction. By creating legal rights that arise directly from stock transactions, Sections 25400 and 25500 regulate those transactions. The majority's statement that Section 25400 regulates only manipulative conduct in California therefore is not correct. The statute also creates liability for damages in connection with out-of-state stock transactions. This violates the Commerce Clause. *See Morley-Murphy Co. v. Zenith Electronics Corp.*, 142 F.3d 373, 378-79 (7th Cir. 1998) (dealership termination statute would violate Commerce Clause if interpreted to allow plaintiff to recover damages based on out-of-state transactions).

In short, the Commerce Clause prohibits California from making determinations about what constitutes securities fraud in connection with securities transactions that take place in other states. Section 25400 violates the Commerce Clause by

regulating transactions wholly outside California between non-California residents.

2. Section 25400 Controls Conduct Outside California

A state statute also violates the Commerce Clause if the statute has "the practical effect of . . . control[ling] conduct beyond the boundaries of the [regulating] State." *Healy*, 491 U.S. at 336. State statutes unconstitutionally regulate a corporation's conduct when they tie a corporation's ability to comply with the regulating state's rules to the corporation's conduct in other, non-regulating states. *Id.* at 338 (holding that it was unconstitutional to require a seller to affirm that its price in the regulating state is no higher than its lowest price elsewhere because this prevents the seller from changing its price elsewhere); *accord Brown-Forman Distillers Corp.*, 476 U.S. at 581-82.

Section 25400, as interpreted by the majority, applies to conduct occurring wholly outside California and could force an out-of-state corporation to alter its conduct in its home state solely to avoid liability under California law. The majority held that for Section 25400 to apply, the only thing that must occur in California is a false statement or omission. The majority opinion stated:

> [T]here is no difficulty in determining if the unlawful statement or omission in violation of subdivision (d) of section 25400 is made in this state and justifies assertion of jurisdiction over the violator. If the statement is made by a person in California *or is willfully disseminated in California*, it is made "in this state."

19 Cal. 4th at 1051 (A21) (emphasis added).

The consequences of this holding are sweeping. Under this standard, any statement that is "willfully disseminated in California" can give rise to liability under section 25400, even if nothing else occurred in California. Thus, the president of a New York company might make a statement in New York to the WALL STREET JOURNAL, which of course is widely

"disseminated in" California. Or the New York company might have a web site accessible to Californians. Or the New York company might put a press release on a national news wire that is available in California. In any of these instances, the New York company's statement could be considered "disseminated in California."[1] A New York purchaser of the company's stock therefore could sue under Section 25400, even though the purchaser, the seller, and the defendant all live in New York and the stock was purchased in New York.

In these examples, California law would impose liability where New York law would not, because New York has no private civil actions for securities fraud. *See CPC Int'l Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 275-76, 514 N.E.2d 116 (1987). The New York corporation may avoid liability under California law only by changing the content of its statements. The California statute therefore would have the effect of controlling the company's conduct in New York. Thus, Section 25400 is unconstitutional because it could control corporations' conduct outside California.

3. Section 25400 Has The Practical Effect Of Producing Inconsistent Legislation

A state statute also violates the Commerce Clause if the statute has the "practical effect" of creating "inconsistent legislation" by "project[ing] . . . one state['s] regulatory regime into the jurisdiction of another State." *Healy*, 491 U.S. at 336-37, *Brown-Forman Distillers Corp.*, 476 U.S. at 583-84.

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[1] The Securities and Exchange Commission has taken a very broad view of what constitutes "dissemination." In the context of foreign internet stock offerings, the SEC has indicated that the offeror may under some circumstances have a duty to block U.S. citizens from accessing web sites containing the offering materials. SEC Release No. 33-7516, 63 Fed. Reg. 14806, 14809 (March 27, 1998). Similarly, the majority's decision here could cause out-of-state companies to block access to their web sites to avoid "dissemination" of that information in California. This would interfere with interstate commerce in violation of the Commerce Clause.

Section 25400 differs in many respects from the securities laws of other states.[2] But because Section 25400 creates liability for securities transactions that occur in those states, Section 25400 projects California's securities laws into commerce in those states. For example, a transaction that occurs entirely in Texas and is completely legal in Texas could give

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[2] Examples of the differences between Section 25400 and other states' analogous securities laws include:

New York law does not allow private civil actions for securities fraud. *See CPC Int'l, Inc. v. McKesson Corp.*, 70 N.Y.2d at 275-76.

Section 25400 does not require privity between the plaintiff and the defendant. *See Mirkin v. Wasserman*, 5 Cal. 4th 1082, 1104, 858 P.2d 568 (1993). Section 25400 is inconsistent with other state laws requiring privity. *See, e.g., Arthur Young & Co. v. Mariner Corp.*, 630 So. 2d 1199, 1204 (Fla. App. 1994) (Florida law requires privity); *In re Catanella and E.F. Hutton & Co., Sec. Litig.*, 583 F. Supp. 1388, 1441 (E.D. Pa. 1984) (New Jersey law requires privity); *Fickinger v. C.I. Planning Corp.*, 556 F. Supp. 434, 437 (E.D. Pa. 1982) (Pennsylvania law requires privity).

Section 25400 does not require that the plaintiff rely directly on the misstatement, adopting the fraud-on-the-market theory. *See Mirkin*, 5 Cal. 4th at 1102. Section 25400 is contrary to other state laws requiring a showing of direct reliance on the misstatement. *See, e.g., Price v. Long Realty, Inc.*, 199 Mich. App. 461, 470, 520 N.W.2d 337 (1993) (Michigan law requires reliance); *Pippenger v. McQuik's Oilube, Inc.*, 854 F. Supp. 1411, 1427 (S.D. Ind. 1994) (Indiana law requires reliance); *Foster v. Alex*, 213 Ill. App. 3d 1001, 1006, 572 N.E.2d 1242 (1991) (Illinois law requires reliance).

Pursuant to Section 25506, an action brought under Section 25400/25500 must be brought within four years of the alleged misconduct or within one-year of discovery of the facts allegedly constituting the violation. Section 25400 is contrary to other states' statute of limitations. *See, e.g.*, CONN. GEN. STAT. § 36b-29(f) (Connecticut has a one-year limit); VA. CODE ANN. § 13.1-522D, ALA. CODE § 8-6-19(f), LA. REV. STAT. ANN. § 51:714(c)(1), MISS. CODE ANN. § 75-71-725 (Virginia, Alabama, Louisiana and Mississippi have a two-year limit); *Kelly v. Primeline Advisory, Inc.*, 256 Kan. 978, 981-82, 889 P.2d 130 (1995) and DEL. CODE ANN. TIT. 6 § 7323(e) (Kansas and Delaware have a three-year limit); IOWA CODE ANN. § 502.504, HAW. REV. STAT. ANN. § 485-20.5, ARK. CODE ANN. § 23-42-106(f) (Iowa, Hawaii and Arkansas have a five-year limit).

rise to liability in California under Section 25400, thereby subordinating Texas laws to California regulation and policies. This situation "create[s] just the kind of competing and interlocking local economic regulation that the Commerce Clause was meant to preclude." *Healy*, 491 U.S. at 337. Section 25400 causes inconsistent legislation by projecting California's securities laws into other states' securities law regimes. Section 25400's extraterritorial reach violates the Commerce Clause.

B. Section 25400 Violates The Commerce Clause By Allowing California Indirectly To Regulate Interstate Commerce

The majority held that any indirect burden on interstate commerce created by Section 25400 is justified by California's local interests. 19 Cal. 4th at 1063 (A41-42). The majority opinion stated that California has a "clear and substantial interest in preventing fraudulent practices in this state which may have an effect both in California and throughout the country. That is the purpose of section 25400." *Id.* The majority concluded that any burden on interstate commerce would be indirect and offset by California's local interests. *Id.*

This Court has held that a state statute violates the Commerce Clause when the statute imposes burdens on interstate commerce that are excessive in relation to local interests that the statute serves. *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970); *Edgar*, 457 U.S. at 643; *Healy*, 491 U.S. at 337 n.14. This balance test looks at (1) the legitimacy of the state's interest in enacting the statute and (2) the burden on interstate commerce in light of the local benefit derived from the statute. *Pike*, 397 U.S. at 142.

In articulating California's interest in enacting this statute, the majority stated that the primary purpose of Section 25400 is to prevent fraudulent practices that may have an effect both in California and "*throughout the country*." 19 Cal. 4th 1063-64 (A41-44) (emphasis added). The court thus recognized that Section 25400 is intended to reach beyond the borders of California and to protect residents of other states.

California does have an interest in preventing deceptive conduct in California, but this interest is limited to protecting residents of California from such conduct. This Court has made it clear that California has no legitimate interest in protecting residents of other states: "While protecting local investors is plainly a legitimate state objective, *the State has no legitimate interest in protecting nonresident shareholders*." *Edgar*, 457 U.S. at 644 (emphasis added). To the extent the statute here creates a cause of action for out-of-state purchasers of stock, California has no legitimate interest to justify the statute's reach.

The majority also stated that California has an interest in preserving the integrity of the California securities markets and ensuring the "flow of out-of-state capital" needed for the growth of California businesses. 19 Cal. 4th at 1063 (A42). But this statute is not designed to serve those interests. The statute applies to out-of-state stock transactions between out-of-state residents – transactions that do not bring any capital into California. The statute applies to out-of-state companies, although California has no interest in ensuring a flow of capital to those companies. Under the majority's own construction, the statute applies to statements made in California without regard to any impact on California investors, California companies, or the California securities markets. *Id.* at 1062 (A40).

Any interest California might claim in regulating out-of-state transactions is further attenuated by the fact that the market for securities is national and is regulated on a national basis. Federal securities laws already give out-of-state investors plenary remedies. Plaintiffs in this case have a parallel federal action seeking recovery for the same harm alleged in this case. Section 25400 is not needed to vindicate whatever interest California might have in preventing deceptive conduct in California that affects out-of-state investors. In short, while California clearly has a legitimate interest in protecting California investors, it is difficult to articulate a legitimate interest for a California statute having a scope that extends throughout the United States.

On the other side of the balance, Section 25400's burden on interstate commerce is significant. As discussed above, Section 25400 burdens interstate commerce by interfering with other states' securities law regimes, forcing companies to alter their business practices, and projecting California's standard of securities fraud into other states. California's interest in enacting Section 25400 is incidental compared to this burden. *See Arizona Corp. Comm'n*, 158 Ariz. at 467-71 (state's legitimate interest in not being a center for illegal securities activity was incidental compared to the burden imposed on interstate commerce). The statute therefore violates the Commerce Clause.

II. The Reform Act Preempts Section 25400 Under The Supremacy Clause

In *Barnett Bank of Marion County, N.A. v. Nelson*, 517 U.S. 25 (1941), this Court held that federal law impliedly preempts state law pursuant to the Supremacy Clause when:

> [a] federal statute . . . create[s] a scheme of federal regulation "so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it." Alternatively, federal law may be in "irreconcilable conflict" with state law. Compliance with both statutes, for example, may be a "physical impossibility," or, the state law may "stan[d] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."

Id. at 31 (citations omitted).

Section 25400 is in "irreconcilable conflict" with the Private Securities Litigation Reform Act of 1995 because the California statute, as interpreted by the majority in this case, stands as an obstacle to Congress' objectives in enacting the Reform Act.

A. Section 25400 Undermines The Purposes Of Congress In Enacting The Reform Act

Congress adopted the Reform Act in response to "significant evidence of abuse in private securities lawsuits." Joint Explanatory Statement of the Committee of Conference, Statement of Managers, H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730 ("Conf. Rep."). Congress found that these abusive practices included "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action[.]" *Id.* Congress also found that plaintiffs had "abuse[d] [ ]the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle[.]" *Id.* Congress further determined that innocent parties are often forced to pay exorbitant settlements. *Id.* at 32. When issuers are forced to "pay lawyers' fees, make settlement payments, and expend management and employee resources in defending a meritless suit, the issuers' own investors suffer. Investors always are the ultimate losers when extortionate 'settlements' are extracted from issuers." *Id.*

Congress passed the Reform Act to cure these abuses. The Reform Act "implements needed procedural protections to discourage frivolous litigation." *Id.* Among these procedural protections is a "[h]eightened pleading standard." *Id.* at 41. The new pleading standard requires a plaintiff to specify with particularity the reasons a defendant's statement is false. 15 U.S.C. § 78u-4(b)(1)(B). Moreover, if plaintiff's allegations are pled on information and belief, the complaint must "state with particularity all facts on which [the plaintiff's] belief is formed." *Id.* The Reform Act also establishes a stringent standard for pleading scienter, which requires a plaintiff to "state with particularity facts giving rise to a strong inference" that each defendant acted with fraudulent intent. *Id.* § 78u-4(b)(2). The Reform Act also imposes a mandatory stay of discovery until the court determines if the

complaint satisfies these rigorous pleading standards. *Id.* § 78u-4(b)(3)(B). The Reform Act also places strict limitations on who can serve as the lead plaintiff representing the plaintiff class in the action. *Id.* § 78u-4(a)(3)(B)(iii). One of the most significant provisions in the Reform Act creates a "safe harbor" from liability for forward-looking statements. *Id.* § 78u-5.

Section 25400 does not have any of these protections. These are not mere technical differences between state and federal procedure. Rather, these protections are the heart of the Reform Act. By forcing plaintiffs to plead *specific* facts showing that the statements were false when made and *specific* facts showing scienter *before* plaintiffs can raid defendants' files, Congress intended to weed out meritless lawsuits based on nothing more than conclusory allegations. The California statute therefore conflicts with the Reform Act. For policy reasons, Congress designed mechanisms for eliminating abusive cases. Under California law, these mechanisms are missing and these "abusive" cases would not be eliminated at the pleading stage. This is a direct conflict.

This case exemplifies this exact conflict. Plaintiffs contend that the defendants knew the alleged statements were false when made. In the federal court case, plaintiffs are subject to the rigorous pleading standards of the Reform Act, *i.e.*, plaintiffs must "state with particularity facts giving rise to a strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). Defendants have filed a motion to dismiss pursuant to that provision and discovery therefore is automatically stayed. But under Section 25400, there is no such pleading hurdle. Plaintiffs' complaint in the California courts therefore survived a pleading challenge and the case is moving forward. Plaintiffs are propounding voluminous discovery requests, undermining the protections against abusive litigation established by the Reform Act.

The conflict between California law and the Reform Act is clearly demonstrated by the fate of the plaintiffs' claims against another defendant in this case, defendant Chong-Moon Lee. As an outside director of Diamond, Mr. Lee is a peripheral defendant in this matter. The state court sustained

his demurrer to the initial complaint. But the court allowed the plaintiffs to obtain discovery before amending their complaint against Mr. Lee. In other words, the court allowed plaintiffs to file their case first, then take discovery in an effort to support it. This is exactly what the discovery stay provisions of the Reform Act are designed to prevent. 15 U.S.C. § 78u-4(b)(3)(B); *see also Medhekar v. United States Dist. Ct.*, 99 F.3d 325, 328 (9th Cir. 1996) ("Congress clearly intended that complaints in these securities actions should stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed."). The California Securities Law therefore undermines Congress' primary objective in enacting the Reform Act: to weed out abusive lawsuits based on conclusory allegations and second-guessing with the benefit of hindsight.

The fact that the California statute undermines the Reform Act is not just speculation. There is empirical support for this proposition. If the Reform Act cuts off abusive and meritless lawsuits, while California law allows such suits to survive, one would expect to see a post-Reform Act shift of lawsuits from federal court to California state court. That is exactly what happened, as the dissenters in the California Supreme Court pointed out. 19 Cal. 4th at 1069 (A52). Justice Brown stated that a study by Stanford Law School's Securities Litigation Law Project found "a sharp increase in securities fraud class action litigation brought under state [securities laws], and a corresponding diminution in comparable federal court SEC-based litigation." *Id., citing* Grundfest & Perino, *Securities Litigation Reform: The First Year's Experience* (Feb. 27, 1997) <http://securities.stanford.edu/report/pslra___yrl/index.html>. The Stanford study shows that the plaintiffs' securities bar is evading the Reform Act's rigorous pleading standards and procedural protections by filing the cases in state courts under state securities laws. *Id.* at 1069-70 (A52-53).

The majority's holding here conflicts with the holdings of several other state courts that have preempted state securities laws due to conflicts with the federal securities laws. In

Guice v. Charles Schwab & Co., 89 N.Y.2d 31, 674 N.E.2d 282 (1996), the defendant brokers made stock trades through market makers. These market makers induced brokers to deal through them by kicking back a part of their profit, called "order flow payments." *Id.* at 38. The brokers would send a confirmation slip to the customers that fully complied with SEC regulations and did not disclose the order flow payment. Plaintiffs, on behalf of a national class, sued under New York state law for breach of fiduciary duty and fraud. *Id.* Relying on *Barnett Bank*, the New York Court of Appeal held that the class claims were preempted by the Securities Exchange Act and SEC regulations. *Id.* at 39. The court found that allowing liability under state law would defeat the objectives of federal law. *Id.* at 47-49. If the courts of each of the fifty states were permitted "to impose civil liability on national securities brokerage firms . . . for failure to meet more stringent common-law agency standards of disclosure of receipt of order flow payments (rather than the Federally mandated uniform specific disclosure . . .)[,] the congressional purpose of enabling the SEC to develop and police [a] 'coherent regulatory structure' for a national market system" would be defeated. *Id.* at 46.

Courts in other states have reached the same result. *See, e.g., Dahl v. Charles Schwab & Co.*, 545 N.W.2d 918, 925 (Minn. 1996) (reasoning that compliance with state laws might lead to an end to the practice of order flow payments, thus conflicting with federal law permitting it; state law preempted), *cert. denied*, 117 S. Ct. 176 (1996); *Eirman v. Olde Discount Corp.*, 697 So. 2d 865 (Fla. App. 1997) (adopting rationale of *Guice* and *Dahl*); *Orman v. Charles Schwab & Co.*, 179 Ill. 2d 282, 297, 688 N.E.2d 620 (1997) (maintenance of state claims by plaintiff class would obstruct the national market system Congress intended to foster; state law preempted), *cert. denied*, 118 S. Ct. 1518 (1998); *McKey v. Charles Schwab & Co.*, 67 Cal. App. 4th 731, 740, 79 Cal. Rptr. 2d 213 (1998) (collecting the cases nationally and adopting the rationale of *Guice* and *Dahl*).

The conflict between this line of cases and the majority's holding here is compelling. Congress clearly intended to

adopt a uniform standard of liability under the Reform Act. To remedy defects with existing pleading standards, Congress adopted "*uniform* and more stringent pleading requirements to curtail the filing of meritless lawsuits." Conf. Rep. at 41 (emphasis added). Congress specifically intended to eliminate liability based on lower standards such as those applied under California law. Congress decided that securities fraud standards should be higher to eliminate meritless lawsuits. The California Securities Law, and Section 25400 in particular, do not set standards equivalent to the Reform Act. Thus, there is no uniformity between the California Securities Law and the Reform Act. The Congressional purpose of the Reform Act would be defeated if the other forty-nine states, like California, could set lower standards and allow abusive class actions to remain alive and well. As the dissent in this case correctly pointed out, the circumstances in this case and those in *Guice* "point to the same conclusion." 19 Cal. 4th at 1071 (A55).

The Reform Act did not expressly preempt state law. The Reform Act left intact the "savings clause" of the Securities Exchange Act of 1934, which permits remedies under state law to co-exist with remedies under federal law. However, this provision does not allow states to enact laws that conflict with or pose an obstacle to federal law. The savings clause states: "nothing in this [Act] shall affect the jurisdiction of the securities commission . . . of any State over any security or any person *insofar as it does not conflict with the provisions of this [Act] or the rules and regulations thereunder.*" 15 U.S.C. § 78bb (emphasis added). Although California may enact its own securities laws, those state laws may not conflict or undermine the federal securities laws.

Last fall, Congress enacted the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353 (the "Uniform Standards Act") in response to efforts by one type of plaintiff to use state law to circumvent the Reform Act in one type of case. In particular, the Uniform Standards Act provides that certain securities class actions against publicly traded companies may not be brought under state law. In those cases, federal securities law provides the exclusive

remedy. 15 U.S.C. § 78bb(f). This is, at best, a partial solution that addressed only one aspect of the problem. For instance, a class action is defined as any action on behalf of a class or brought on behalf of 50 or more investors, *id.*, so the Uniform Standards Act does not affect suits brought by individuals or groups of investors. It applies only to claims against publicly traded companies, not private companies or limited partnerships. *Id.* It does not apply to tender offers or proxy statements. *Id.*

The majority cited the enactment of the Uniform Standards Act as evidence that Congress did not intend the Reform Act to preempt state law. The majority opinion stated that because Congress in the Uniform Standards Act expressly preempted certain types of securities actions, it may be inferred that Congress intended to leave all other actions "unrestricted" and those actions therefore are not impliedly preempted. 19 Cal. 4th at 1046 & n.12 (A12-13). In essence, the majority held that Congress' express preemption of certain cases means there can be no implied preemption of others. The majority's reasoning is directly contrary to a decision of this Court. In *Freightliner Corp. v. Myrick*, 514 U.S. 280 (1995), this Court held that express statutory preemption does not foreclose the possibility of implied preemption and does not "obviate the need for analysis of an individual statute's pre-emptive effects." *Id.* at 287-89. Thus, the majority erred in finding that there was no *implied* preemption under the Reform Act because Congress did not *expressly* preempt in the subsequent Uniform Standards Act. By focussing on the intent of Congress at the time of the Uniform Standards Act, the majority also committed the mistake of attributing the intent of a *later* Congress to an *earlier* Congress. The issue that is relevant to the implied preemption analysis is whether state law would undermine the intent of the Congress that enacted the Reform Act in December 1995. The intent of the Congress that enacted the Uniform Standards Act in November 1998 is irrelevant to that inquiry.

There is no evidence that Congress considered the question of whether the specific California statute in question here is consistent with the purposes of the Reform Act. In fact, the

majority's sweeping interpretation of Section 25400 had not even been issued yet when the Uniform Standards Act was enacted. It therefore would have been impossible for Congress to determine that Section 25400, as broadly interpreted by the majority opinion, provided a remedy that should be allowed to co-exist with Reform Act remedies.

The dissenters correctly analyzed the implied preemption issue:

> [I]f state courts resolutely ignore implied preemption principles, the effect of Congress's passage of the Reform Act will be to offer securities plaintiffs and their class counsel a "safe harbor" from which to evade the effects of the Reform Act. And that is exactly what has happened. Congress is now aware of the trend toward circumventing the Reform Act's impediments to securities class action litigation by migrating to state courts as the forum of choice. Indeed, Congress has acted with unusual speed to pass legislation precluding state court forum-shopping by securities class action counsel. . . . Congress has *expressly* preempted state securities laws as of November 1998 with the enactment of the Uniform Standards Act. Before that date, however, Congress had *impliedly* preempted state blue sky provisions, including California's, that are in "irreconcilable conflict" with the provisions of the Reform Act itself.

19 Cal. 4th at 1070 (A54-55). Section 25400 undermines and irreconcilably conflicts with the objectives of the Reform Act. Under the Supremacy Clause, the statute is preempted.

B. Section 25400 Specifically Undermines The Reform Act's Safe Harbor Provisions

The need for preemption of Section 25400 is clearest with respect to liability for "forward-looking" statements. Congress carved out this category of statements for special treatment because Congress was especially concerned about abusive claims of fraud based on no more than the fact that a

defendant's forecast did not come true. Congress therefore created a safe harbor from liability based on forward-looking statements. California law lacks this safe harbor, creating a situation where California could impose liability for statements that Congress specifically decided to immunize. This is a direct, irreconcilable conflict between state and federal law.

In the Conference Report that accompanied the Reform Act, Congress emphasized the importance of encouraging companies to disclose projections and other forward looking statements: "Understanding a company's own assessment of its future potential [is] among the most valuable information shareholders and potential investors could have about a firm." Conf. Rep. at 43. Congress expressly determined that the existing system of private securities litigation had a "muzzling effect" on "the willingness of corporate managers to disclose information to the marketplace" and has harmed shareholders by creating a "chilling effect . . . on the robustness and candor of disclosure," because companies and their officers are subjected to liability if they disclose projections that later turn out to be inaccurate. *Id.* at 42-43. In particular, Congress was concerned about the chilling effect of abusive securities litigation on technology companies, such as Diamond Multimedia: "Technology companies – because of the volatility of their stock prices – are particularly vulnerable to securities fraud lawsuits when projections do not materialize." *Id.* at 43.

Congress' solution to this problem was the creation of the "safe harbor" designed "to enhance market efficiency by encouraging companies to disclose forward-looking information" without fear of liability. *Id.* The goal of the safe harbor is "to provide certainty that forward-looking statements will not be actionable by private parties . . . if they are accompanied by a meaningful cautionary statement." *Id.* at 44. The safe harbor has two prongs. A defendant is not liable if the defendant accompanies the forward-looking statement with "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement," *or* if the defendant does not have actual knowledge that the forward-looking

statement is false. 15 U.S.C. § 78u-5(c)(1). Either prong of the safe harbor provides a defendant with immunity.

The majority erroneously concluded that Section 25400 did not conflict with the Reform Act's safe harbor provision. The majority botched its statement of the two prongs of the safe harbor:

> the immunity [the safe harbor] creates does not insulate forward-looking statements that omit information about factors that may cause actual results to differ materially *and/or* are made with actual knowledge that the statement is false and misleading.

19 Cal. 4th at 1057 (A31-32) (emphasis added). The majority's sloppy use of the ambiguous phrase "and/or" inaccurately states the safe harbor. The court should have said "and," because both conditions listed by the court must apply for liability to attach under the Reform Act.

The majority's inaccuracy in its statement of the safe harbor is not just a grammatical misstep. Rather, the inaccuracy hides a gap in the court's analysis. The majority held that because the complaint in this action alleged that the defendants knew the alleged statements were false when made, the Section 25400 claim does not conflict with the "actual knowledge" standard established by the federal safe harbor. 19 Cal. 4th at 1058 (A33). In other words, the court concluded that the two statutes have the same standard of liability. But the court did only half the analysis: it discussed only one of the two prongs. The court did not discuss the alternate prong of the safe harbor, which immunizes forward-looking statements from liability if they are accompanied by meaningful cautionary language. This prong provides a separate defense from liability under federal law. This prong of the safe harbor is not consistent with Section 25400, which has no comparable provision. A forward-looking statement accompanied by cautionary language that is immune from liability under federal law can be the basis of liability under Section 25400.

Section 25400 therefore stands in direct conflict with the federal statute and undermines Congress' intent to encourage

companies to make forward-looking statements. The state statute must yield to the federal safe harbor.

III. There Is A Compelling Need For This Court To Decide The Constitutionality Of Extraterritorial Application Of State Securities Laws

As the majority opinion recognized, 19 Cal. 4th at 1045 (A10-12), the issue here is of great significance. After the Reform Act, there was a dramatic increase in state court securities class action filings. For the first ten months of 1996, the number of securities actions filed in state courts nationally jumped 65% versus the comparable period in 1995. *See* Dean Starkman, "Securities Class-Action Suits Immune to Effects of New Law," DOW JONES NEWS SERVICE, Nov. 12, 1996. The sudden increase in state court securities suits is an obvious ploy to avoid the Reform Act and to turn state securities laws into a regulatory scheme for interstate transactions. The holding in this case has done exactly that. Until this Court resolves the constitutionality of state regulation of interstate securities transactions that are subject to the Reform Act, there will be an obvious and open path for securities plaintiffs to make an end-run around the Reform Act: sue under California law. This Court should review this issue now.

Congress recently affirmed the importance of protecting the integrity of the Reform Act by passing the Uniform Standards Act. However, the Uniform Standards Act is an ineffective solution to the larger problem. It does not apply retroactively and therefore does not affect numerous state law class actions pending when it was enacted, such as this action. Even more significantly, the Uniform Standards Act, while addressing one problem, left other avenues for abuse. The Act does not apply to state law actions where damages are sought on behalf of fewer than 50 persons. 15 U.S.C. § 78bb (f)(5)(B). This is a major gap. A study shows that a group of 49 or fewer plaintiffs often represents the lion's share of alleged damages claims in the average securities case. Elliot

J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2088-90 (June 1995). The Uniform Standards Act also does not apply to claims against privately held companies or limited partnerships. 15 U.S.C. § 78bb(f)(5)(E) (act applies only to "covered securities," *i.e.*, generally those listed on national exchanges or on NASDAQ). Nor does the act apply to tender offers or proxy materials. 15 U.S.C. § 78bb(f)(3).

The Uniform Standards Act therefore does not address many cases that may be filed in state court under state law. In these cases, the issues discussed in this petition will continue to arise. In California, the courts will continue to allow claims by out-of-state plaintiffs based on out-of-state transactions, implicating the Commerce Clause. The California courts will continue to allow plaintiffs to evade the restrictions of the Reform Act and to impose liability based on forward-looking statements that are protected by the federal safe harbor. Given the breadth of the majority's interpretation of the statute, securities plaintiffs will be able to bring cases under California law even when plaintiffs' claims arise in another state. In fact, plaintiffs will not often need to file cases under the law of other states. Because California law has been interpreted to cover all statements disseminated in California, virtually every statement regarding any publicly traded company will be subject to California law. California law will become the "law of choice" for state law securities claims. Now that the California Supreme Court has spoken in this case, that court is unlikely to accept another case presenting these issues. This case therefore presents this Court with its best opportunity to address these issues; indeed, there may not be another good chance to do so.

Securities lawsuits can cost into the millions of dollars to defend. By enacting the Reform Act, Congress set out to stop abusive and meritless cases. Section 25400 stands as a threat to the fulfillment of Congress' intent. Plaintiffs will continue to evade the federal law and undermine Congress' intent until this Court addresses the scope of state securities laws. Accordingly, this Court should accept review of this matter

and should issue a writ of certiorari to the California Supreme Court.

CONCLUSION

Petitioners respectfully request that the Court grant this petition.

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APPENDIX A

IN THE SUPREME COURT OF CALIFORNIA

DIAMOND MULTIMEDIA SYSTEMS, INC. et al., Petitioners, v. SUPERIOR COURT OF SANTA CLARA COUNTY, Respondent; JOANNE PASS et al., Real Parties in Interest.	S058723 Ct. App. 6 H016376 Santa Clara County Super. Ct. Nos. CV758927, CV759012 and CV759270 (Filed Jan. 4, 1999)

Corporations Code section 25400, a part of the Corporate Securities Law of 1968 (§ 25000 et seq.),[1] provides that it is unlawful in this state to make false statements or engage in specified fraudulent transactions which affect the market for a security when done for the purpose of inducing purchase or sale of the security or raising or depressing the price of the security. In short, it prohibits market manipulation.[2] Section 25500 creates a civil

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[1] All statutory references are to the Corporations Code unless otherwise stated. References to the Corporate Securities Law are to the Corporate Securities Law of 1968.

[2] " 'Manipulation' is 'virtually a term of art when used in connection with securities markets.' *Ernst & Ernst*, 425 U.S. at 199. The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity. See, *e.g.*, § 9 of the 1934 Act, 15 U.S.C. § 78i (prohibiting specific manipulative practices); *Ernst & Ernst, supra*, at 195, 199 n. 21, 205; *Piper v.*

remedy for buyers or sellers of stock[3] the price of which has been affected by the forms of market manipulation proscribed by section 25400.

The principal question in this mandamus action is whether that civil remedy is available to out-of-state purchasers who bought or sold a stock whose price was affected by market manipulation if the purchase or sale took place outside the State of California. The matter reached this court after the Court of Appeal summarily denied a petition for writ of mandate by which petitioners, defendants in the underlying lawsuit, sought to compel the Santa Clara County Superior Court to sustain their demurrer and dismiss a class action seeking damages under section 25500 for an alleged violation of section 25400. This court granted review and issued an order to show cause. We conclude that this action is properly brought under sections 25400 and 25500 and affirm the judgment of the Court of Appeal.

Chris-Craft Industries, Inc., ante, at 43 (Rule 10b-6, also promulgated under § 10(b), is 'an antimanipulative provision designed to protect the orderliness of the securities market during distributions of stock' and 'to prevent stimulative trading by an issuer in its own securities in order to create an unnatural and unwarranted appearance of market activity'). . . . " (*Santa Fe Industries, Inc. v. Green* (1977) 430 U.S. 462, 476.)

[3] The definition of "security" encompasses many other kinds of financial interests. (See § 25019.) Because this litigation, as is true of most litigation raising the issues addressed here, involves stock, we refer to "stock" rather than "security."

I

The Superior Court Action

Plaintiff Joanne Pass filed the underlying action as a class action on behalf of all purchasers of the common stock of Diamond Multimedia Systems, Inc. (Diamond Multimedia) between October 26, 1995, and June 20, 1996, except the named defendants and their families. The named defendants are Diamond Multimedia, Hyung Hwe Huh, its senior vice-president and chief technical officer; William J. Schroeder, board member, president, and chief executive officer; Gary B. Filler, senior vice-president and chief financial officer; and Chong-Moon Lee, founder and chairman of the board. Lee, Filler, and Schroeder controlled Diamond Multimedia through their board positions and stock ownership.

A. General allegations.

The complaint alleges[4] that all of the individual defendants were aware of adverse nonpublic information about Diamond Multimedia's business, finances, product, markets and present and future business prospects. Each was aware of and approved false statements issued by or on behalf of Diamond Multimedia during the class period.[5] The November 1995 stock offering which

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[4] For purposes of ruling on a demurrer, the court assumes the truth of all well-pleaded allegations of a complaint. The ability of the plaintiff to prove them is not in issue. (*Lazer v. Superior Court* (1996) 12 Cal.4th 631, 635.)

[5] The allegedly false and misleading statements made during the class period included statements in Security and Exchange Commission filings in conjunction with an offering of

followed raised over $94 million for Diamond Multimedia while the individual defendants each received more than $2 million for the shares they sold, based on their insider information, at the artificially inflated price.

Diamond Multimedia is a manufacturer and supplier of graphics accelerator and modem products, having its executive offices and principal place of business in San Jose, California. Its shares are traded on the NASDAQ National Market system.[6] During the class period the shares rose from just under $20 per share on April 13, 1995, to over $40 per share in December 1995. At the time

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shares. Allegedly the filings overstated assets, and omitted information about significant problems with Diamond Multimedia products which the statement described only generally. Other allegations are directed to publicity generated by the company about new product introduction which allegedly was intended to offset concern that the stock offering would dilute earnings, false and misleading information about the company provided to securities analysts which relied on that information in making buy recommendations and projecting increased earnings and a target price for Diamond Multimedia shares of $44 to $47 in their reports. The complaint included specifics regarding the "true" facts of which defendants were aware including customer dissatisfaction with and decreased demand for Diamond Multimedia products, canceled orders, "massive" return of products, unreliable suppliers, inadequate inventory control, overstated and obsolete inventory, and accounting practices which were not prepared in accordance with generally accepted accounting practices and were designed to falsely reflect continued financial success at a time when defendants allegedly knew that business was "collapsing" and revenues were declining dramatically.

[6] NASDAQ is an acronym for National Association of Security Dealers Automated Quotation System.

of a November 1995 offering, Diamond Multimedia sold 3.15 million shares, the individual defendants sold 315,041 shares at prices in the $30 per share range. In January through March 1996, the individual defendants sold 226,672 shares and in April and May 1996, they sold $136,250 worth of shares. The price of the shares had declined to the $20 per share range at that time. The price fell to as low as 9 1/8 per share following a June 20, 1996, revelation by Diamond Multimedia that it would suffer a loss and subsequent admission that it would write down its inventory.

The plaintiff class includes California residents and others throughout the United States. Pass alleged that she had purchased 800 shares of Diamond Multimedia stock on May 17, 1996, at 18 3/4 per share. The place of purchase is not stated.

B. The section 25400 cause of action.

The complaint purports to state a cause of action under subdivision (d) of section 25400 which provides: "It is unlawful for any person, directly or indirectly, in this state: [¶] . . . [¶] (d) If such person is a broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security, to make, for the purpose of inducing the purchase or sale of such security by others, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or which omitted to state any material fact necessary in order to make the statements made, in the light of the

circumstances under which they were made, not misleading, and which he knew or had reasonable ground to believe was so false or misleading."

In support of section 25400 cause of action, the complaint alleges that defendants individually and pursuant to a conspiracy, or as aiders and abetters of one another, made untrue statements of material facts, omitted to state material facts necessary to make the statements not misleading, and engaged in acts, practices, and a course of conduct which operated as a fraud and deceit upon class members in order to sell their own Diamond Multimedia shares or induce the purchase of Diamond Multimedia stock by plaintiff and members of the class. Defendants sold or offered for sale Diamond Multimedia shares during the class period or willfully participated in such sales or offerings for sale. Defendants offered to sell or sold Diamond Multimedia shares by means of written or oral communications which included untrue statements of a material fact or omitted to state material facts necessary to make the statements not misleading. Members of the plaintiff class suffered damages because they relied on the integrity of the market when they purchased Diamond Multimedia shares at artificially inflated prices. Plaintiffs would not have purchased the shares at the price paid or at all had they been aware that the market price had been artificially and falsely inflated by defendants' misleading statements and concealments. At the time of their purchases the fair market value of the shares was substantially less than the price paid by class members.

Compensatory and punitive damages, pre- and post-judgment interest, attorneys and experts fees, and equitable or injunctive relief were sought.

Diamond Multimedia and all of the individual defendants except Lee (collectively Diamond Multimedia or defendants) demurred generally (Code Civ. Proc., § 430.10, subd. (e)) on the ground that the complaint did not state facts sufficient to constitute a cause of action as to either cause of action.[7]

The first of several bases for relief offered by Diamond Multimedia in support of its demurrer to the Corporate Securities Law cause of action was an argument that the complaint failed to plead the jurisdictional prerequisite for actions under sections 25400 and 25500 because there was no allegation that any stock purchases were made "in this state."[8] Legislative history materials accompanied the memorandum of points and authorities. At the hearing on the demurrer, Diamond Multimedia argued that the legislative history of sections 25400 and 25500 reflected an intent to protect California investors, i.e., California residents or persons who purchase stock in California.

The trial court overruled the Diamond Multimedia demurrer to the Corporate Securities Law cause of

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[7] Lee demurred specially. His demurrer on grounds of uncertainty was overruled. On the other grounds stated (particularity, standard of pleading), it was sustained with leave to amend, but the court ruled he could not be held liable under section 25400 for aiding and abetting or conspiracy.

[8] Diamond Multimedia also argued that the individual defendants could not be held liable under sections 25400/25500 and that Diamond Multimedia could not be held liable for statements not made in connection with the November 1995 stock offering. It sought to have all allegations based on those statements stricken.

action.[9] It ruled that plaintiffs had adequately alleged that the defendants made misstatements for the purpose of inducing purchase of Diamond Multimedia stock, but the individual defendants were not liable for aiding and abetting under section 25400, and Diamond Multimedia could not be held liable for statements that were not made in connection with the November 1995 stock offering.

This petition followed.

II

Petition for Writ of Mandamus

The petition for writ of mandamus seeks a peremptory writ directing the superior court to vacate the order overruling Diamond Multimedia's demurrer to the Corporate Securities Law cause of action and to enter a new order sustaining that demurrer. Diamond Multimedia seeks relief on the ground that the complaint fails to state a cause of action under sections 25400 and 25500 because it does not allege that plaintiffs are domiciled in California or that their purported Diamond Multimedia stock transactions occurred in California.

The dispute between defendants/petitioners and the real parties in interest (plaintiffs) centers on the introductory clause of section 25400: "It is unlawful for any person, directly or indirectly, *in this state*:" to do any of the

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[9] The complaint also set forth a cause of action for violation of Civil Code sections 1709-1710 (deceit). A demurrer to the deceit cause of action was sustained with leave to amend for the reason that reliance had not been adequately pleaded.

proscribed acts constituting market manipulation. (Italics added.) Plaintiffs argue that this language defines only the place at which the proscribed acts occur, and that the plain language of sections 25400 and 25500 does not limit the liability for violation of section 25400 to persons who bought or sold affected stock in California. They rely in part on this court's statement in *Mirkin v. Wasserman* (1993) 5 Cal.4th 1082, 1104, that liability extends to " 'any person trading in the market.' " *Mirkin* is not dispositive, however, as the quoted statement was dictum and was not made with reference to the place at which a section 25500 plaintiff bought or sold stock. While *Mirkin* was a class action, apparently on behalf of a nationwide class, the action was for deceit and misrepresentation under Civil Code sections 1709 and 1710. Liability under sections 25400 and 25500 was not in issue. Our reference to civil remedies available under those provisions responded only to a claim that those remedies were inadequate and required privity of contract between the plaintiff and the defendant. The question here is one of first impression in this court.

Diamond Multimedia contends that "in this state" also defines the location at which a purchase or sale affected by the market manipulation takes place. It argues that it was the legislative intent to regulate and assert jurisdiction only over the offer and sale of securities in California and that the Corporate Securities Law regulates only intrastate securities transactions. Based on this reasoning Diamond Multimedia finally argues that the law imposes civil liability only for violations affecting intrastate transactions. Therefore, it claims, it is not enough that the seller is located in California. The purchaser must also be in California.

To reach this conclusion Diamond Multimedia reasons that while section 25500 does not state that the private cause of action is available only to persons who purchase stock in California, it refers back to section 25400. By doing so the Legislature incorporated the "in this state" limitation of section 25400. Therefore, section 25400 applies to persons who attempt to induce a purchase "in this state," while section 25500 provides a remedy for persons who purchase stock sold in violation of section 25400. Diamond Multimedia argues that, because section 25400 is intended to protect those who are induced to purchase stock in California, it is logical to conclude that section 25500 provides a remedy *only* for those who purchase stock in this state.

III

Discussion

Diamond Multimedia urges this court to construe the civil remedy afforded by section 25500 narrowly so that California will not provide a more attractive forum and afford more expansive remedies for market manipulation than does federal securities law. It does appear that recent procedural changes applicable to the federal securities laws have resulted in the filing of an increased number of nationwide class action lawsuits on behalf of corporate shareholders in California courts under California law.[10]

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[10] These changes were adopted in the Private Securities Litigation Reform Act of 1995, P.L. No. 104-67 (Dec. 19, 1995) 109 Stat. 737, 1995 Code Cong. & Admin. News No. 2 (PSLRA). The Report to the President and Congress on the First Year of Practice under the Private Securities Litigation Reform Act of

We agree with petitioners that, as a result of the PSLRA, the reach of the California Corporate Securities Law is

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1995, authored by the Office of the General Council of the Securities and Exchange Commission (Apr. 1997) at pages 30-31 (reprinted in the PLI Corporate Law & Practice Course Handbook Series No. B0-0013 (1997)) states, relying in part on a National Economic Research Associates study, that in the 10 months following enactment of the law 78 cases had been filed in state courts as compared with 48 for the prior year. Another study reported that 40 percent of securities class actions filed in the first 10 months of 1996 were filed in state courts. In 1995 slightly more than 20 percent were filed in state court. The state court filings after enactment of the act appeared to the author to be attributable to the availability of discovery while a motion to dismiss was pending. The Stanford Securities Class Action Clearinghouse reported that of 39 state court actions that were "stand alone," i.e., not parallel to a federal action, 24 were filed in California.

Three factors were identified as making state courts attractive – first the holding in *Matsushita Electric Industries Co. v. Epstein* (1996) 516 U.S. 367, that a state court dismissal of a securities fraud class action pursuant to a settlement could include a provision barring suit in federal court based on the same transaction. The other two factors relate specifically to California – the absence of a reliance requirement, and the availability of jurisdiction over many high technology firms whose stocks are sold during periods of high volatility and whose officers and directors often receive a large part of their compensation in company stock and stock options.

The Stanford University study originally found only on-line (http:// securities, stanford.edu) is now available in the Practicing Law Institute Corporate Law and Practice Course Handbook Series. (See Grundfest & Perino, Securities Litigation Reform: The First Year's Experience (Feb. 1997) reprinted at PLI Corporate Law & Practice Course Handbook Series No. B4-7199 (1997); see also Perino, Testimony before Subcom. on Securities, U.S. Sen. Com. on Banking, Housing & Urban Affairs (July 24, 1997) reprinted as A Census of Securities Class Action Litigation

increasingly important to shareholders, corporations, and the judicial system. The importance of the question is reflected in this court's grant of review and issuance of its order to show cause.

Whether California courts should entertain shareholder class actions based on alleged market manipulation which may not be maintained under federal law is a legislative policy decision, however. While the burden on California courts and corporate defendants may increase if actions predicated on violation of section 25400 are properly brought under California law, the function of this court is only to construe and apply the law so as to carry out the legislative intent which underlies it.[11] Defendants' policy-based arguments must be addressed to Congress and/or the Legislature.[12]

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after the Private Securities Litigation Reform Act of 1995, PLI Corporate Law & Practice Course Handbook Series No. B4-7199 (Sept. 1997).)

[11] As *Mirkin v. Wasserman, supra,* 5 Cal.4th 1082, demonstrates, however, nationwide class actions for market manipulation are permissible quite apart from the provisions of the Corporate Securities Law. Section 25400 is a preferred remedy because, unlike an action predicated on fraud or deceit, it is not necessary to demonstrate reliance on the defendant's false or misleading statement in the purchase or sale of the security.

[12] Insofar as class actions are concerned, recently enacted federal legislation, which is inapplicable to pending actions, may accomplish what defendants urge this court to do by adopting their construction of sections 25400 and 25500. The Securities Litigation Uniform Standards Act of 1998 (Sen. No. 1260, 105th Cong., 2d Sess.(1998)) amends section 16 of the federal Securities Act of 1933 (15 U.S.C. § 77p) and section 28 of the Securities Exchange Act of 1934 (15 U.S.C. § 78bb) to

This action presents only a question of law. Neither the wisdom of the legislation nor the merits of the

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prohibit class actions based on state statutory or common law by a private party "alleging – [¶] (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or [¶] (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security."

Section (c) of the act expressly provides, however: The amendments made by this section shall not affect or apply to any action commenced before and pending on the date of the enactment of this Act." Notwithstanding the effort of Justice Brown to draw analogies between this action and the issues in *Guice v. Charles Schwab & Co., Inc.* (1996) 89 N.Y.S.2d 31, and *Dahl v. Charles Schwab & Co.*, (Minn. 1996) 545 N.W.2d 918, neither those cases nor the others on which Justice Brown relies holds that federal law preempts actions by shareholders for damages suffered as a result of market manipulation.

Far from restricting market manipulation actions to those brought under federal securities law, Congress has chosen both to permit continuance of pending class actions based on misrepresentation or omissions of material fact and use of manipulative or deceptive devices in connection with a purchase or sale of securities and to leave individual actions unrestricted. The suggestion that federal securities law already impliedly preempted all such actions under the Corporate Securities Law of 1968 ignores this clear Congressional recognition that, except to the extent that the 1998 act limits class actions, there is no preemption. Shareholders' rights under state and federal law are cumulative. By enacting only a class action limitation, when it could have barred all actions based on state law to recover losses caused by market manipulation, Congress has confirmed the independent force of state securities law. Had Congress believed that its goals could not be accomplished if suits based on state law were permitted or that any conflict between state a federal law existed, all actions based on state law, not simply class actions, would have been banned.

underlying lawsuit is before us. We address only the proper construction of sections 25400 and 25500. As with any statutory construction inquiry, we must look first to the language of the statute. "To determine legislative intent, a court begins with the words of the statute, because they generally provide the most reliable indicator of legislative intent." (*Hsu v. Abbara* (1995) 9 Cal.4th 863, 871.) If it is clear and unambiguous our inquiry ends. There is no need for judicial construction and a court may not indulge in it. (*In re Waters of Long Valley Creek Stream System* (1979) 25 Cal.3d 339, 348.) "If there is no ambiguity in the language, we presume the Legislature meant what it said and the plain meaning of the statute governs." (*People v. Snook* (1997) 16 Cal.4th 1210, 1215.)

The central premise of Diamond Multimedia's argument is that section 25400 prohibits market manipulation with the intent to induce a purchase or sale of stock "in this state" and that, therefore, the section 25500 remedy is available only if the plaintiff purchased or sold stock in California. We are not persuaded that section 25400 can reasonably be read in the manner suggested by defendants. In arguing that it was the legislative intent to regulate only intrastate securities transactions, Diamond Multimedia fails to acknowledge that section 25400 does not regulate securities transactions other than those described in section 25400 which are undertaken "in this state" to manipulate the market. It regulates market manipulation, not third party transactions affected by market manipulation. Section 25500 simply provides a remedy for third parties whose sale or purchase of stock is affected by unlawful conduct in California, making the

remedy available without any express territorial limitation.

Section 25400 does not, as defendants/petitioners suggest, provide that the acts constituting market manipulation must be done with the intent to induce the purchase or sale of stock in California by a third party. Moreover, the manipulative conduct is unlawful under several provisions of section 25400 regardless of whether any third party purchase or sale actually occurs. Subdivision (d), under which this action has been filed, does not require that any transaction occur. It makes it unlawful in California to knowingly make false or misleading statements for the purpose of inducing the purchase or sale of stock.

The language of section 25400 is very clear. It states: "It is unlawful for any person . . . in this state" to engage in any of the conduct described thereafter. Thus, it is unlawful under subdivision (a) of section 25400 for a person or entity in California, for market manipulation purposes, to engage in "wash sales," specifically stock transactions which do not involve a change in beneficial ownership, or entering buy or sell orders knowing that other orders of the same size at the same price are being made at the same time. Under subdivision (b) it is unlawful in California to make a series of stock trades to create the appearance of active trading in the stock or to raise or depress the price of the stock when done to induce a purchase or sale. Subdivision (c) makes it unlawful for broker-dealers or persons offering to sell or buy a stock in California to induce a purchase or sale through "tipster sheets," i.e., by circulating information that the price of the stock may rise or fall because of market operations

conducted for the purpose of raising or depressing the price. Subdivision (d) makes it unlawful in California for sellers or buyers of stock to make false or misleading statements of material facts for the purpose of inducing a purchase or sale.[13] Finally, subdivision (e) makes it unlawful in California for any person for consideration received from another to induce a purchase or sale of stock through tipster sheets.

Diamond Multimedia argues, however, that "in this state" should be read to modify the intent provisions of section 25400, not simply describe the location in which the proscribed conduct must take place – that a defendant must be shown to have intended to induce the purchase or sale of stock by others "in this state." As so modified, it would follow in Diamond Multimedia's view that section 25500 provides a remedy only to those persons who purchase or sell affected stock in California.

Diamond Multimedia suggests that this proposed construction of sections 25400 and 25500 would further the legislative intent that the law protect California domiciliaries even those who purchase stock outside California inasmuch as section 25008 deems out-of-state purchases by California domiciliaries to be made in this

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[13] Contrary to the assertion of amici curiae Washington Legal Foundation and Allied Educational Foundation, an out-of-state securities seller may not be found liable under plaintiffs' construction of section 25400 if, while attending a one-day conference in California, the person omits to state a material fact about a security. Civil and criminal liability under section 25400 attach only if a person omits a material fact for the purpose of inducing the sale or purchase of the stock with knowledge that the omission was false or misleading.

state. That is true only if the stock is delivered to the purchaser in California, however. (§ 25008, subd. (a).) Thus a resident of California who purchased Diamond Multimedia stock in Nevada during the class period might have no recourse under the Corporate Securities Law while a Nevada domiciliary could seek relief under the law if he or she used the services of a California broker to complete the purchase in California.

Moreover, the language of sections 25400 and 25500 is not susceptible to this transposition of the phrase "in this state" in the manner suggested by petitioners. As plaintiffs note, even were we to transpose the "in this state" limitation in section 25400 as suggested by defendants, engaging in any of the conduct described in subdivisions (a), (b), and (d) of section 25400 for the purpose of inducing the purchase or sale of stock in California would still constitute a violation of that section regardless of whether any stock was sold or of the location at which other persons actually purchased or sold the stock. Reading section 25400 as suggested by defendants would not preclude suit under section 25500 by persons who purchased affected stock outside of California because section 25500 creates liability for any willful violation of section 25400 to "any" person who buys or sells stock at the artificially inflated or deflated price.

Only if one accepts defendants' additional thesis that because violation of section 25400 requires intent to induce a sale or purchase of stock in California and section 25400 is intended to protect only persons who purchase or sell stock in California, could we conclude that only those persons may exercise the section 25500 remedy. Section 25500 would thus incorporate the "in this

state" restriction petitioners read into subdivision (d) of section 25400. Acceptance of this theory would necessitate not only transposing the "in this state" restriction from the introductory sentence which refers to the conduct proscribed by section 25400, but also ignoring the section 25500 creation of liability to "any person" who purchases or sells affected stock.

Were we to read section 25400 as suggested by defendants, we would have to assume that the Legislature did not intend the Commissioner of Corporations, who also has power to enforce section 24500 (see § 25530 et seq.), to enjoin manipulative conduct by California licensed stockbrokers and dealers whose intent is to affect the national market in a stock or to enjoin such conduct before any transactions in the stock are affected by the conduct.

We would also have to overlook the impact of that reading on criminal prosecution for violation of section 25400. The legislative intent that subdivisions (a), (b), and (d) of section 25400 define conduct that is unlawful "in this state" and that violation of those subdivisions occurs regardless of whether a third party California transaction results is reflected in section 25540, subdivision (b). That section provides felony criminal penalties for "[a]ny person who willfully violates Section 25400, 25401, or 25402." If intent to induce a purchase or sale of stock in this state and a transaction in this state were elements of the violation, criminal prosecution of a person who sought to influence the price of stock on a national exchange would not be possible. The statute does not impose the limitations petitioners suggest. The conduct proscribed in subdivisions (a), (b), and (d) of section 25400 is criminal if, in California, the defendant acted

with the intent to induce any purchase or sale of stock regardless of whether it results in a third party purchase or sale of an affected stock.

In short, in subdivisions (a), (b), and (d) of section 25400 the Legislature made acts of market manipulation in California a felony. It did not make them so only if the defendant intended to affect only the market for stocks in California or only if California stock transactions resulted. Assuming, arguendo, that a stock transaction in California is an element of a violation of subdivisions (c) and (e) of section 25400, as the Legislature has provided that it is unlawful "in this state" to induce a purchase or sale by means of tips about potential market operations, there would still be liability to buyers in other states.

Subdivisions (c) and (e) of section 25400 make it unlawful "to induce the purchase or sale" of a stock by circulating tipster sheets. Section 25008 provides inter alia, that a sale of a security is made in California when the offer to sell is made "in this state" or an offer to buy is accepted in California. (§ 25008, subd. (a).) An offer to sell is made "in this state" if the offer originates from California. (§ 25008, subd. (b).) Thus, a sale occurs "in this state" even if the purchaser is in, and communicates acceptance of the offer to sell from, New York. Thus, while aftermarket out-of-state purchases and sales might not qualify as purchases and sales induced "in this state," a California corporation which offered its shares for sale on a nationwide basis would be liable to out-of-state purchasers who accepted the offer. This follows because under section 25008, a sale occurs in California if the offer emanates from this state. The purchaser, who has a right to sue under section 25500, may be in another state.

Petitioners' argument that section 25400 does not apply to interstate transactions thus fails.

As noted above, resort to section 25008, which defines "in this state" for the purpose of determining when a stock transaction takes place in California does not aid Diamond Multimedia's argument. To the extent that section 25400 prohibits stock transactions for market manipulative purposes in subdivisions (a) and (b), section 25008 applies to establish whether that conduct occurred in California. The definition of "in this state" is not restrictive, however, and does not operate to confine liability for violation of section 25400 to intrastate transactions. This is apparent when the section 25008 definitions are applied to violations of subdivisions (c) and (e) of section 25400.

These section 25008 definitions, which clearly encompass interstate transactions, necessarily extend liability for stock transactions induced by conduct made unlawful by subdivisions (c) and (e) of section 25400 beyond those which occur wholly within California. Under defendants' reading of section 25400, however, it would be unlawful to engage in that type of manipulative conduct only if the purchaser was in California, and the section 25500 remedy would be available only if the stock was purchased by a person in California. That reading of section 25400 would render the section 25008 definition of sale "in this state" superfluous as it would deny a remedy to the purchaser even if the offer to sell had been made in this state.

Inasmuch as section 25008 does apply in determining when "in this state" a defendant "induce[s] a sale of

stock" by circulation of a tipster sheet, a violation may occur when the stock is purchased by a person in New York and the person in New York has a remedy under section 25500. There is no reason to believe that the Legislature intended to deny a remedy to an out-of-state purchaser for market manipulation in violation of subdivision (d) of section 25400 that it has provided to the same purchaser for violation of subdivisions (c) and (e) of that statute.

Nor is it surprising that in section 25008 the Legislature did not define when a false or misleading statement is made "in this state" for purposes of subdivision (d), of section 25400. Subdivision (d) does not prohibit stock transactions and thus the definitions of section 25008 are not implicated. Section 25400, subdivision (d) prohibits false or misleading statements or omissions, when made for the purpose of manipulating the market for a stock. There is no need to provide a definition for "in this state" in that context. Unlike a stock transaction, in which the buyer and seller or offeree and offeror may be in different states, there is no difficulty in determining if the unlawful statement or omission in violation of subdivision (d) of section 25400 is made in this state and justifies assertion of jurisdiction over the violator. If the statement is made by a person in California or is willfully disseminated in California, it is made "in this state." Thus, while we recognize that the Legislature did not provide an alternative definition of "in this state" for subdivision (d) of section 25400, there was no need for it to do so.

The introductory clause of section 25400 prohibits commission of manipulative acts in California.[14] It does not say in subdivision (d) that it is (1) unlawful in California to engage in market manipulation (2) with the intent to induce a purchase or sale of stock in California (3) if a purchase or sale of the stock in California is affected by the manipulative conduct.

This court is not free to insert as elements of a section 25400 violation a requirement that the defendant intend to induce a sale in California or that, insofar as subdivisions (a), (b), and (d) are concerned, that there actually be an affected third party transaction in stock, nor is it free to impose limits on civil liability that do not exist for criminal liability under the same statute.

Section 25400 says and implies nothing about the person or persons who may enforce section 25400 or obtain relief for violation of section 25400. That subject is covered in section 25500 et seq. Insofar as this action is concerned, section 25500 applies, creating civil liability for the violation of section 25400 and making relief available to "any person." Section 25500 provides:

"Any person who willfully participates in any act or transaction in violation of Section 25400 shall be liable to

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[14] Transposition of "in this state" to each of the subdivisions of section 25400 would create additional anomalies that would be inconsistent with the purpose of the prohibition of market manipulation. A person attempting to affect the market in a stock to induce a purchase or sale in California could simply enter buy or sell orders, or engage in the sale and/or purchase of the stock outside California and thereby escape liability under subdivisions (a), (b), and (c) of section 25400.

any other person who purchases or sells any security at a price which was affected by such act or transaction for the damages sustained by the latter as a result of such act or transaction. . . . " (Italics added.)

Section 25500 does not limit a violator's liability to persons who purchase or sell stock in California. "Any" person affected by acts of market manipulation which take place in California may recover damages from the violator. Moreover, section 25500 is not the only provision of the law creating civil liability for violation of section 25400. In subdivision (b) of section 25530, the Corporate Securities Law of 1968 expressly permits the Commissioner of Corporations to seek relief on behalf of investors, and, like section 25500, section 25530, subdivision (b) contains no language limiting "investors" to California investors. It provides: "If the commissioner determines it is in the public interest, the commissioner may include in any action authorized by subdivision (a) [for injunctive relief] a claim for ancillary relief, including but not limited to, a claim for restitution or disgorgement or damages *on behalf of the persons injured* by the act or practice constituting the subject matter of the action, and the court shall have jurisdiction to award additional relief." (*Ibid.*, italics added.)

Comparison of section 25400 with other parts of the Corporate Securities Law of 1968 leads to the same conclusion. When the Legislature intended that a purchase or sale of a stock must occur in California if the buyer or seller is to be subject to civil, criminal, or administrative penalties, it said so without the necessity of transposing

the "in this state" proviso as Diamond Multimedia suggests we do in section 25400. Thus, section 25402 provides that it is unlawful for an issuer or insider "to purchase or sell any security of the issuer *in this state* at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public. . . . " (Italics added.) There the Legislature did not, as it did in section 25400, provide that "it is unlawful . . . in this state" to use insider information in the purchase or sale of stock. Similarly, in section 25401 the Legislature expressly limited the scope of the prohibition of false or misleading statements in an offer to buy or sell. That section makes it "unlawful for any person to offer or sell a security *in this state* or buy or offer to buy a security *in this state* by means of any written or oral communication which includes an untrue statement. . . . " (*Ibid.*, italics added.) In sections 25110 and 25130, the Legislature again made it unlawful to offer or sell an unqualified security "in this state." In short, the various provisions of the Corporate Securities Law of 1968 are quite specific in describing those unlawful practices in which a purchase or sale must occur in California.[15] In those sections, the Corporate Securities Act regulates securities transactions in California. Section 25400, by contrast, does not regulate third party securities transactions. Its focus is the prevention of manipulation of the market price of securities. The only transactions section 25400 regulates are manipulative

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[15] Even there, however, by virtue of section 25008, interstate transactions may be made "in this state."

transactions in California. The price of most stock is established on a national market. For that reason section 25400 is not concerned with whether the third party sale or purchase of a stock affected by such manipulation takes place in California and does not limit the right to recover for damage caused by market manipulation to persons who buy or sell stock in California.

As plaintiffs note, had the drafters and the Legislature intended to restrict in every case the civil liability of persons who engage in practices made unlawful by section 25400, they could easily have done so in section 25500 by inserting the "in this state" limitation in that section. It would then have read: "Any person who willfully participates in any act or transaction in violation of Section 25400 shall be liable to any other person who purchases or sells any security *in this state* at a price which was affected by such action or transaction. . . ." The drafters and the Legislature did not do so, however, and it is not our function to insert language omitted by the Legislature. (*Manufacturers Life Ins. Co. v. Superior Court* (1995) 10 Cal.4th 257, 274.)

A conclusion that the Corporate Securities Law is directed only to intrastate transactions would be inconsistent with section 20008 which establishes the criteria by which to determine if offers to sell, sales, offers to purchase, and purchases are made in California. Section 20008 clearly contemplates interstate transactions. Under section 25008, "(a) [a]n offer or sale of a security is made in this state when an offer to sell is made in this state, or an offer to buy is accepted in this state. . . . [¶] (b) [a]n offer to sell or buy is made in this state when the offer either originates from this state or is directed by the

offeror to this state and received at the place to which it is directed. An offer to buy or to sell is accepted in this state when acceptance is communicated to the offeror in this state; and acceptance is communicated to the offeror in this state when the offeree directs it to the offeror in this state. . . . " These definitions bring interstate transactions within the scope of California regulation, and section 25500 provides for service of process on out-of-state defendants.

Defendants argue nonetheless that this court should consider the legislative purpose in enacting the Corporate Securities Law – that of regulating securities in the intra-state market not reached by federal securities regulation. We have no doubt that this was the intent of the drafters of the Corporate Securities Law and, presumably, the Legislature. It does not follow, however, that the civil remedies created by section 25500 are available only to persons who bought or sold securities in California. It is apparent that extending those remedies to any person affected by the proscribed forms of manipulative conduct has a far greater deterrent impact than limiting a defendant's exposure to civil liability for in-state transactions would have done. Thus we have no reason to infer that the omission in section 25500 of any territorial limitation was inadvertent or that the Legislature anticipated that, by proscribing manipulative conduct occurring only "in this state" in section 25400, the Legislature anticipated that section 25500 would be construed as permitting civil recovery only if a purchase or sale of stock affected by the proscribed conduct occurred "in this state." The language of sections 25400 and 25500 do not lend themselves to the construction urged by defendants.

Defendants ask that we consider not only the context in which the Corporate Securities Law was enacted, but also available legislative history in the form of comments made by the committee appointed by then Commissioner of Corporations Harold R. Volk which drafted the law when the law was submitted to the Legislature and by Commissioner Volk and Professor Harold Marsh, Jr., the reporter of that committee, in their treatise, Practice Under the California Corporate Securities Law of 1968 (1969). We decline the invitation. Only when the language of a statute is susceptible to more than one reasonable construction is it appropriate to turn to extrinsic aids, including the legislative history of the measure, to ascertain its meaning. (*Granberry v. Islay Investments* (1995) 9 Cal.4th 738, 744.)

We note, however, the materials cited by defendants are not inconsistent with our conclusion that the civil remedies of sections 25500 are not limited in the manner suggested by Diamond Multimedia. The drafters' comments confirm that the purpose of the Corporate Securities Law is to give greater protection to California residents than that available under the prior law or federal law, but they do not suggest that the law was not intended to protect all persons affected by market manipulation that occurs in California.

The drafting committee was appointed by Commissioner of Corporations Volk to review the then-applicable 1917 Corporate Securities Law to determine if it gave sufficient protection to investors, was unduly burdensome on legitimate businessmen, and consider if the 1917 law was generally adequate to the regulatory problems in the 1967 securities market. (Volk, Preface to Proposed

Corporate Securities Law of 1968 (Oct. 20, 1967); Drafting Com., Introduction to Proposed Corporate Securities Law of 1968 (hereafter Drafting Committee Report).) Diamond Multimedia relies on the final sentence of a paragraph of the Introduction to support its argument that the intent of the drafters was to regulate only intrastate stock transactions: "There has long been a need in California to clearly define what acts constitute a violation of our securities law. The fraudulent and prohibited practices enumerated in Part 5 are modeled upon existing Federal laws, both statutory and common law, which are applicable to all interstate securities transactions. The latter constitute by far the bulk of the securities market in California. The effort here is to more clearly define the acts which are malum prohibitum *and to apply the prohibitions to the intrastate securities market* which is the greater state regulatory problem when compared to the interstate market." (Drafting Com. Rep., *supra*, at p. iii, italics added.)

This statement is not inconsistent with a conclusion that the civil remedies of section 25500 are available to both in-state and out-of-state purchasers and sellers affected by market manipulation occurring in California. Section 25400 defines those practices which are prohibited in California. Extending civil remedies for violating those provisions to all affected purchases is fully consistent with a purpose of applying the prohibitions themselves to intrastate conduct.

When describing section 25400 specifically, Marsh and Volk note that unlike liability under sections 25401 and 25501 under which a violator is liable only to persons with whom he or she deals, under section 25500 "the defendant may be *liable to any person* trading in the market

for any length of time that the market price may have been affected by his misstatement. In view of this potentially enormous and virtually unlimited liability, the intent of the defendant to affect the market by inducing the purchase or sale of the security by others was a necessary qualification of the defendant's liability." (1 Marsh & Volk, Practice Under the Cal. Securities Laws (1998) § 14.05[2][e], p. 14-50, italics added (Marsh & Volk).) In the same discussion the authors explain why the plaintiff must establish fault as an element of a cause of action under subdivision (d) of section 25400. "[I]t is not an unreasonable requirement for holding a defendant *liable for everyone's trading losses* in the market for an indefinite period of time to insist that the plaintiff prove that the defendant did something wrong." (Marsh & Volk, *supra*, § 14.05[2][e], p. 14-50, italics added.) This explanation of the drafters' intent is inconsistent with a conclusion that a section 25400 violator must intend to induce a purchase or sale "in this state." And in their paragraph on "Persons Entitled to Recover," the authors note that, while sections 25501 and 25502 under which privity of contract between the defendant and plaintiff, under section 25500 the defendant who violates section 25400 is liable to "any other person" whose trade is affected by the unlawful conduct of the defendant. (Marsh & Volk, *supra*, § 14.05[5], p. 14-53.) Again there is no suggestion that only persons who bought or sold stock in California may seek relief under section 25500 for a section 25400 violation.[16]

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[16] Walter G. Olson, vice-chairman of the drafting committee, wrote shortly after the Corporate Securities Law become effective: "[L]iability for violation of [section 25400] flows to any and all persons who purchase or sell a security at a

The contention that state exercise of jurisdiction over interstate transactions would somehow be inconsistent with federal law and thus violate the Supremacy Clause (U.S. Const., art. VI, cl.2) also lacks merit. The Securities Exchange Act of 1934 (15 U.S.C. § 78bb(a)) makes it clear that, except to the extent it has been subsequently modified by the Securities Litigation Uniform Standards Act of 1998, federal law in this arena supplements, but does not displace state regulation and remedies. "Congress plainly contemplated the possibility of dual litigation in state and federal courts relating to securities. See 15 U.S.C. § 78bb(a) (preserving 'all other rights and remedies that may exist at law or in equity')." (*Matsushita Electric Industrial Co., Ltd. v. Epstein, supra*, 516 U.S. at p. 383; see also *Securities and Exchange Commission v. National Securities, Inc.* (1969) 393 U.S. 453, 461; *Johnson-Bowles Co., Inc. v. Division of Securities etc.* (Utah Ct.App. 1992) 829 P.2d 101, cert. den. 843 P.2d 516; *E.F. Hutton & Co., Inc. v. Rousseff* (Fla. 1989) 537 So.2d 978.)[17]

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price affected by the act or transaction. . . . [T]he potential plaintiffs include everyone who buys or sells the securities affected." (Olson, *The California Corporate Securities Law of 1968*, 9 Santa Clara L.Rev. (1968) 75, 98, fn. omitted.)

[17] 15 United States Code section 78bb, subdivision (a): "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Except as otherwise specifically provided in this chapter, nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person

Neither Diamond Multimedia nor Justice Brown has identified any direct or indirect conflict between sections 25400/25500 and any provision of the federal securities laws applicable to this litigation. As noted above (see fn. 12, *ante*), the Securities Litigation Uniform Standards Act of 1998 has no impact on this case. And, contrary to defendants' suggestion that the complaint in this action seeks to impose liability on the basis of forward-looking statements that are protected by federal law under 15 United States Code section 78u-5, plaintiffs allege, inter alia, that petitioners are liable for market manipulation on the basis of false and misleading statements and omissions, which statements, under section 25500, were made "willfully." Subdivision (c) of 15 United States Code section 78u-5, the "Safe Harbor" provision, immunizes forward-looking statements only "in any private action arising under this chapter," (*id.*, § 78u-5(c)(1)) i.e., under the Securities and Exchange Act of 1934. Moreover, assuming, as does Justice Brown, that Congress intended a wider application of the Safe Harbor provision, the immunity it creates does not insulate forward-looking statements that omit information about factors that may

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insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder. No State law which prohibits or regulates the making or promoting of wagering or gaming contracts, or the operation of 'bucket shops' or other similar or related activities, shall invalidate any put, call, straddle, option, privilege, or other security, or apply to any activity which is incidental or related to the offer, purchase, sale, exercise, settlement, or closeout of any such instrument, if such instrument is traded pursuant to rules and regulations of a self-regulatory organization that are filed with the Commission pursuant to section 78s(b) of this title."

cause actual results to differ materially and/or are made with actual knowledge that the statement is false and misleading.[18] The complaint alleges falsity, omission of such factors, and actual knowledge. While the allegation of actual knowledge may not extend to all of the

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[18] 15 United States Code section 78u-5 provides in pertinent part:

"(c) Safe Harbor

"(1) In general

Except as provided in subsection (b) of this section, in any private action arising under this chapter that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) of this section shall not be liable with respect to any forward-looking statement whether written or oral, if and to the extent that –

"(A) the forward-looking statement is –

"(i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual result to differ materially from those in the forward-looking statement; or

"(ii) immaterial; or

"(B) the plaintiff fails to prove that the forward-looking statement –

"(i) if made by a natural person was made with actual knowledge by that person that the statement was false or misleading; or

"(ii) if made by a business entity; was –

"(I) made by or with the approval of an executive officer of that entity; and

"(II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading."

allegedly false and misleading statements, a complaint is sufficient and must be upheld if it states a cause of action on any theory. (*American Airlines, Inc. v. County of San Mateo* (1996) 12 Cal.4th 1110, 1118; *Alliance Mortgage Co. v. Rothwell* (1995) 10 Cal.4th 1226, 1232.) For that reason, defendants' demurrer was properly overruled.

If plaintiffs establish at trial that defendants knew their statements were false and misleading, imposition of civil liability for violation subdivision (d) of section 25400 will not conflict with federal law.

Amicus curiae Adobe Systems Incorporated (Adobe) suggests that the proper focus for construing sections 25400/25500 is on the latter section.[19] It argues that the "in this state" language of section 25400 need not be considered. Instead, we should apply a presumption against extraterritoriality in remedial statutes. Adobe relies on our application of that presumption in *North Alaska Salmon Co. v. Pillsbury* (1916) 174 Cal. 1, a decision construing the then-applicable workers' compensation law. A worker who entered into a contract with a California corporation for employment as a fisherman was injured in Alaska. The Industrial Accident Commission awarded compensation. On the employer's appeal this

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[19] Adobe asks that the court take judicial notice of the reply brief filed by plaintiffs present counsel in *Mirkin v. Wasserman, supra*, 5 Cal.3rd 1082, in which counsel stated that the Corporations Code does not address the remedies available to open market purchasers who claim fraud. While judicial notice is permissible under Evidence Code sections 452 and 459, we deny the request. What counsel argued in another case is irrelevant to the proper construction of sections 25400/25500.

court annulled the award, holding that the right to compensation was controlled by the applicable statutes, not the contract, and the statute did not give the commission jurisdiction to award compensation for out-of-state injuries.

The court also stated: "Although a state may have the power to legislate concerning the rights and obligations of its citizens with regard to transactions occurring beyond its boundaries, the presumption is that it did not intend to give its statutes any extraterritorial effect. The intention to make the act operative, with respect to occurrences outside the state, will not be declared to exist unless such intention is clearly expressed or reasonably to be inferred 'from the language of the act or from its purpose, subject matter or history.' " (*North Alaska Salmon Co. v. Pillsbury, supra,* 174 Cal. at p. 4.) We found nothing in the Workmen's Compensation, Insurance and Safety Act, to indicate that the compensation provisions of that law were intended to apply to injuries suffered in other jurisdictions and also noted that there was strong authority that workers' compensation statutes are not to be given extraterritorial effect absent an express declaration that do so. On that basis we held that the commission had exceeded its jurisdiction. (*Id.* at p. 7.)

As discussed above, however, unlike the injury in *North Alaska Salmon Co. v. Pillsbury, supra,* 174 Cal. 1, the conduct which gives rise to liability under section 25400 occurs in California.

The presumption applied in *North Alaska Salmon* to a workers' compensation statute has never been applied to an injured person's right to recover damages suffered as a

result of an unlawful act or omission committed in California.[20] Civil Code section 3281 provides that "[e]very person who suffers detriment" from unlawful acts or omissions in California may recover damages from the

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[20] Adobe identifies *EEOC v. Arabian American Oil Co.* (1991) 499 U.S. 244, as an application of the presumption against extraterritoriality on which it relies. There, however, as in *North Alaska Salmon v. Pillsbury, supra,* 174 Cal. 1, the wrongful act as well as the injury occurred in the foreign jurisdiction. As the high court explained in *EEOC v. Arabian American Oil Co., supra,* 499 U.S. at page 248, the presumption against extraterritoriality serves to prevent clashes between the laws of the United States and other nations. Sections 25400 and 25500 provide a remedy for a wrongful act committed in California. There is no potential in this for a "clash" between California law and that of any other state or of the United States.

The presumption against extraterritoriality is one against an intent to encompass *conduct* occurring in a foreign jurisdiction in the prohibitions and remedies of a domestic statute. (See, e.g., *Smith v. United States* (1993) 507 U.S. 197, 203-204 [presumption against extraterritorial application of United States law requires that doubts as to the reach of the Federal Tort Claims Act be resolved against its encompassing torts committed in Antarctica]; see also 73 Am.Jur.2d (1974) Statutes, § 359 [Absent clearly expressed contrary intent the presumption is that statute is intended to have no extraterritorial effect, but to apply only in jurisdiction of state or country enacting it.]; *Tattis v. Karthans* (Miss. 1968) 215 So.2d 685 [words spoken in North Carolina not actionable under Mississippi state statute]; *Marmon v. Mustang Aviation, Inc.* (Tex. 1968) 430 S.W.2d 182 [Texas wrongful death statute does not provide remedy for death occurring in Colorado accident]; *Burns v. Rozen* (Fla.Dist.Ct.App. 1967) 201 So.2d 629 [Florida statute regulating method of taking fish applied only to territorial waters of state]; *Dur-ite Co. v. Industrial Commission* (Ill. 1946) 394 Ill. 338 [worker's compensation law does not encompass persons employed outside State of Illinois].)

person at fault. Product liability actions against California manufacturers by persons injured elsewhere by a defective product manufactured in California are a prime example of actions authorized by Civil Code section 3281. (See, e.g., *Stangovik v. Shiley, Inc.* (1991) 54 Cal.3d 744; *Shiley, Inc. v. Superior Court* (1992) 4 Cal.App.4th 126; *Holmes v. Syntex Laboratories, Inc.* (1984) 156 Cal.App.3d 372.) We see no reason to conclude that the Legislature intended a different result for actions based on violation of section 25400.

Diamond Multimedia argues that four federal decisions support its construction of sections 25400 and 25500. They do not. The first of those cases, *In re Victor Technologies Securities Litigation* (N.D. Cal. 1984) 102 F.R.D. 53 (*Victor Technologies*), actually supports plaintiffs. The decision does not address section 25400 in disposing of a motion for class certification. The opinion states only that state law claims, alleging false and misleading statements in a registration statement and prospectus filed with the Securities and Exchange Commission, were brought under sections 25500 and 25502. After addressing the requirements for class certification of rule 23(a) and (b) of the Federal Rules of Civil Procedure (28 U.S.C.), the court considered defendants' argument that class certification for the state law claim should be denied on the ground that only persons who purchased stock in California could maintain a cause of action.

The district court rejected the argument, holding: "The jurisdictional prerequisites of a claim filed under section 25500 are satisfied when offers of securities are made from California to persons outside the state, or when acceptance of the offer is directed to a person

within California. See Cal. Corp. Code § 25008(b). *See generally* Marsh & Volk, *Practice under the California Securities Laws*, § 3.08[1] (1983).[¶] As the offering materials in this action apparently emanated from Victor's California headquarters, and the buyers' acceptance were apparently directed at a California entity, it is appropriate to certify a plaintiff class for this claim. It should be emphasized, however, that the class certification for the claims filed under the California Corporations Code includes only those purchasers of Victor stock who purchased in direct response to the initial March 23 public offering. Those who purchased Victor stock on the open market at some point after the initial public offering will not be part of the sub-class entitled to proceed under sections 25500 and 25501 of the California Corporations Code. (Of course, if those who purchased later were California purchasers, they will be entitled to maintain a claim under the California Code.)" (102 F.R.D. at p. 60.)

Victor Technologies thus affirms that out-of-state purchasers may state a claim under section 25500. While it also holds that aftermarket purchasers may not do so unless they purchased their shares in California, there is no mention of section 25400, no consideration of the language of that section, and neither analysis or explanation of the conclusion. On that point the decision is not persuasive authority.

Victor Technologies was followed by *Weinberger v. Jackson* (N.D.Cal. 1984) 102 F.R.D. 839.) Again the decision disposed of a motion for class certification. Without discussion, the district court followed *Victor Technologies*, and certified a nationwide class action which sought relief under federal law and sections 25400 and 25500, but

excluded aftermarket purchasers who did not purchase their stock in California. Again, there was no discussion or analysis of section 25400. The district court said only "Aftermarket purchasers not purchasing in California are not part of the class as to the California Corporations Code claims. *See also In re Victor Technologies Securities Litigation*, 102 F.R.D. 53, 60 (N.D. Cal. 1984)." (102 F.R.D. at p. 847.)

In *In re Activision Securities Litigation* (N.D. Cal. 1985) 621 F.Supp. 415, claims were brought under federal law and sections 25400/25500, 25401/25501, and 25504/25504.1 for sale of securities by means of an allegedly misleading registration statement and prospectus. The district court, again without discussion or analysis, excluded non-California aftermarket purchases from the class. It said only: "[M]embers of the plaintiff class who purchased Activision stock over-the-counter after the public offering should not be included in the class for claims filed under the California Corporations Code unless they purchased the stock in California. *Victor Technologies*, 102 F.R.D. at 60; *Weinberger v. Jackson*, [102 F.R.D. 839]." (621 F.Supp. at p. 432.) The court failed to notice the distinction between section 25400, which contains no such requirement, and sections 25401 and 25504 pursuant to which a purchase or sale by means of misleading communications must be "in this state."

Scholes v. Tomlinson (N.D. Ill. 1992) 145 F.R.D. 485, made the same mistake. The Illinois class representative alleged violations of section 25110, 25400, subdivision (d), and 25401. Quoting *McFarland v. Memorex* (N.D. Cal. 1982) 96 F.R.D. 357, the court stated: " 'Only purchasers who can show the requisite contacts with California can

satisfy the jurisdictional limitations of Cal. Corp. Code, Section 25008.' *McFarland v. Memorex Corp.*, 96 F.R.D. 357, 364. (N.D. Cal. 1982). 'These sections apply only to purchasers who buy a security in California . . . '. *McFarland*, 96 F.R.D. at 364." (145 F.R.D. at p. 493.) In *McFarland v. Memorex, supra*, 96 F.R.D. 357, the action was brought under sections 25401/25501, however. There was no section 25400/25500 claim.

Thus, while the federal decisions which have considered nationwide class actions under section 25400, have erroneously excluded aftermarket purchasers, they do recognize the right of out-of-state purchasers to seek relief under that section. They do not support defendants' contention that no out-of-state purchasers may bring a section 25400 action.

Diamond Multimedia has cited, and we have found, no decisions in the courts of our sister states in which actions on behalf of a nationwide class or out-of-state purchasers of securities brought under state securities laws have been dismissed because plaintiffs did not purchase the securities in the state. An interstate class action by an out-of-state purchaser of bonds was permitted in *Rosenthal v. Dean Witter Reynolds, Inc.* (Colo. Ct. App. 1994) 883 P.2d 522. There the plaintiffs alleged, inter alia, fraudulent conduct in connection with the offer and sale of a security in violation of the Colorado Securities Act (Colo.Rev.Stat. § 11-51-123(3) (1987)). There the court upheld the right of a Pennsylvania purchaser of bonds issued and offered for sale in Colorado to represent a nationwide class of purchasers, rejecting a claim that the entire transaction had to occur in Colorado. In so doing the Colorado court noted that *Simms Investment Co. v. E.F.*

Hutton & Co. (M.D.N.C. 1988) 699 F.Supp. 543, held that the Colorado securities law and the North Carolina common law of fraud could apply to a claim that defendants had made misrepresentations and omissions to induce the plaintiff to participate in a joint venture. The court read *Simms* as holding that, and agreed that, Colorado law applied if either the offer or the sale took place in Colorado. Quoting *Simms*, the Colorado court observed: "Blue Sky laws 'protect legitimate resident issuers by exposing illegitimate resident issuers to liability, without regard to the markets of the issuer.' *Simms Investment Co. v. E.F. Hutton & Co.*, 699 F.Supp. at 545.)" (*Rosenthal v. Dean Witter Reynolds, Inc., supra*, 883 P.2d at p. 531.) On certiorari, the Colorado Supreme Court affirmed the judgment of the Court of Appeals, holding that class certification was proper. Colorado law applied as the misleading statements in the offer to sell were made in Colorado. It was irrelevant that the purchase was made through a broker in Pennsylvania. (*Rosenthal v. Dean Witter Reynolds, Inc.* (Colo. 1995) 908 P.2d 1095, 1104.)

Finally, we reject the claim that permitting out-of-state investors to recover damages under section 25500 would impose an impermissible burden on interstate commerce. Amici curiae Securities Industry Association, et al., argue that if section 24500 is construed as regulating out-of-state or interstate transactions in securities, the law may violate the commerce clause (U.S. Const., art. I, § 8). That arguments [sic] fails to recognize that section 24500 regulates only manipulative conduct in California. It does not purport to regulate any "transactions" in securities which occur outside of this state (cf. *Healy v. The Beer Institute* (1989) 491 U.S. 324; *Edgar v. MITE Corp.*

(1982) 457 U.S. 624) and does not discriminate against interstate commerce.

Amici curiae fail to explain how permitting persons who purchase or sell stock at a time when the market price is affected by market manipulation occurring in California to recover damages from the California malefactor burdens interstate commerce. Indeed, such recovery is allowed under federal securities law and we are unable to see how permitting recovery under section 25500 for violation of section 25400 imposes any burden on interstate commerce. Quite, the opposite. By affording a remedy to persons who are the victims of manipulative conduct, section 25500 stimulates commerce in corporate stock.

Even were there some indirect burden on interstate commerce, that burden would not be constitutionally impermissible. While petitioners and several amici curiae argue that California has no legitimate interest in protecting out-of-state investors, it has a clear and substantial interest in preventing fraudulent practices in this state which may have an effect both in California and throughout the country. That is the purpose of section 25400. While substantial criminal penalties are available, the Legislature might reasonably conclude that imposing civil liability for all trading losses occasioned by proscribed manipulative conduct will be a substantial deterrent to violation. Even assuming arguendo that California had no interest in protecting investors in other states, the Legislature may reasonably conclude that California does have a legitimate interest in discouraging unlawful conduct that has a potential to harm California investors as

well as persons in other states. (See also *Hurtado v. Superior Court* (1974) 11 Cal.3d 574, 583 [Purpose of wrongful death statute creating remedy for nonresidents as well as residents is to deter conduct that wrongfully takes life in this state.].) Extending the civil liability remedy to all investors serves that purpose.

It is true a state may not claim that its interest in protecting nonresident shareholders offsets a burden the state law imposes on interstate commerce. (See *Edgar v. MITE Corp., supra,* 457 U.S. at p. 644.) As noted earlier, however, section 25400 does not regulate stock transactions in other states and section 25500 does not penalize or discourage such transactions. Section 25400 may discourage fraudulent inducement of those transactions, but any indirect burden that places on out-of-state sales is clearly offset by the state interest in preventing fraud and protecting the integrity of the capital market for all investors.

California also has a legitimate and compelling interest in preserving a business climate free of fraud and deceptive practices. California business depends on a national investment market to support our industry. The California remedy for market manipulation helps to ensure that the flow of out-of-state capital necessary to the growth of California business will continue.[21] The

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[21] This point is emphasized by amici curiae the International Brotherhood of Teamsters and the Service Employees International Union which note that Taft-Hartley pension plans, public pension plans, and company-sponsored stock investment plans have collectively invested over $500 billion in securities. They assert that protection of this

Court of Appeal rejected a claim similar to that of petitioners and recognized the importance of extending state-created remedies to out-of-state parties harmed by wrongful conduct occurring in California in *Clothesrigger, Inc. v. G.T.E. Corp.* (1987) 191 Cal.App.3d 605. There the plaintiff sought damages for fraud, negligent misrepresentation and unfair business practices in the charges made by defendant for long distance telephone calls. The trial court denied certification of a nationwide class on the ground that a nationwide class was not suitable as California had no interest in providing greater protection to residents of other states than that provided by their home states. The Court of Appeal reversed that order, noting that defendant had identified no interest of any other state that might be affected by extending California's law to the injured nonresidents, and recognizing that "California may have an important interest in applying its law to punish and deter the alleged wrongful conduct." (*Id.* at p. 615.)

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nationwide group of investors is effective only if the Corporate Securities Law of 1968 provides remedies to investors both within and outside California. Amicus curiae National Council of Senior Citizens states that the investment of public and private pensions had reached $1.3 trillion by 1992. They note that even California residents would suffer losses from market manipulation for which they would have no remedy under section 25500 if their pension plan made its investments in other states. This concern is echoed by two such pension plans, amici curiae Missouri State Employees' Retirement System and Pennsylvania State Employees' Retirement System which state that they regularly invest substantial sums in securities of California corporations.

We conclude for all of these reasons that out-of-state purchasers and sellers of securities whose price has been affected by the unlawful market manipulation proscribed by section 24500 may avail themselves of the remedy afforded by section 25500. The remedy is not limited to transactions made in California. The trial court properly overruled petitioners' demurrer.

IV

Disposition

The order of the Court of Appeal summarily denying the petition for writ of mandate is affirmed.

BAXTER, J.

WE CONCUR:

GEORGE, C.J.
MOSK, J.
KENNARD, J.
WERDEGAR, J.

DIAMOND MULTIMEDIA SYSTEMS, INC. et al. v. SUPERIOR COURT, COUNTY OF SANTA CLARA

S058723

DISSENTING OPINION BY BROWN, J.

I

Plaintiffs contend that both the language and legislative history of California's Corporate Securities Law of 1968 (Corp. Code, § 25000 et seq.)[1] demonstrate "a clear . . . intent" that the Act applies "to interstate as well as intrastate transactions." But that construction is belied by the text of the Act itself, by statements of its principal drafter, by commentators and securities litigation practice, and by court decisions. According to these interpretations, spanning more than 30 years, the Act was never intended to have an extraterritorial effect. Instead, it was drafted and enacted in the expectation that it would *supplement* the federal securities acts, statutes that apply to and regulate a truly nationwide securities market. That was the view of the Act and its role from the outset. In a letter dated April 19, 1968, to Senator Randolph Collier, a member of the California Senate Committee on Finance, Harold Marsh, Jr., a corporate law professor and the reporter for the committee of experts appointed to draft what became the Act, wrote that in drafting the legislation, the committee "tried to reach a balanced judgment as to how far it was possible for California to go in asserting jurisdiction over . . .

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[1] References to the Act are to the Corporate Securities Law of 1968.

predominately foreign transactions and, as a matter of policy, how far it *should* attempt to go." (Sen. Com. on Finance on Assem. Bill No. 1 (1968 Reg. Sess.) April 19, 1968, Letter to Sen. Collier, p. 5.) The committee sought "to give the greatest possible protection to California investors and at the same time to recognize that *California cannot rule the United States.*" (*Ibid.*, italics added.)

Professor Marsh's view of the Act's strictly intrastate application has been the almost unanimous consensus for more than a quarter-century. Because of the widely shared assumption that California's Blue Sky statute did not apply to out-of-state transactions, there simply was no litigation seeking to apply it extraterritorially. It was not until after Congress passed the Private Securities Litigation Reform Act of 1995, Pub.L. No. 104-67 (Dec. 22, 1995) 109 Stat. 737 (1995 U.S. Code Cong. & Admin. News, No. 1) (the Reform Act), legislation intended by its sponsors to put a stop to what the Senate report called "frivolous 'strike' suits alleging violations of the Federal securities laws in the hope that defendants will quickly settle to avoid the expense of litigation," (1995 U.S. Code Cong. & Admin. News, No. 2, at pp. 679, 683, reproducing Sen. Rep. No. 104-98 on P.L. No. 104-67 (June 19, 1995) 679, 683 (the Reform Act Report)) that serious, concerted efforts were mounted by the securities plaintiffs class action bar to widen the territorial scope of the California Blue Sky statute.

Before this litigation – founded on a revisionist history of the Act's purpose and scope – efforts were concentrated on enlarging the California statute by amendment. The ill-fated Proposition 211, rejected by California voters at the November 1996 election by a

3-to-1 margin, would have added Section 25400.1 to the Act, containing almost identical language to existing Section 25400, subdivision (d), but removing the limiting words "in this state." (See Ballot Pamp., Prop. 211: Text of Proposed Law, Gen. Elec. (Nov. 5, 1996) § 3, p. 95.) If, as the majority now assumes, existing Corporations Code section 25400 et seq.[2] has always authorized nationwide blue sky suits, why was the initiative provision needed? Of course, today's decision makes the defeat at the polls inconsequential. The court now magnanimously flings open the doors the voters emphatically closed. Indeed, the court insists on welcoming these actions despite Congress's repeated attempts to curtail them.

II

On November 3, 1998, the President signed into law the Securities Litigation Uniform Standards Act of 1998 (Sen. No. 1260, 105th Cong., 2d. Sess. (1998) (the Uniform Standards Act)). Among other effects, the Uniform Standards Act expressly preempts state blue sky laws, like California's Act, and "makes Federal court the exclusive venue for most securities class action lawsuits." (Joint Explanatory Statement of the Com. of Conf., Uniform Standards Act of 1998, 144 Cong. Rec. H10,774 (daily ed. Oct. 13, 1998).) The joint statement goes on to describe the Uniform Standards Act as intended "to prevent plaintiffs from seeking to evade the protections that Federal law

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[2] All statutory references are to the Corporations Code unless otherwise stated.

provides against abusive [securities class action] litigation by filing suit in State, rather than in Federal, court" and to "protect the interests of shareholders and employees of public companies that are the target of meritless 'strike' suits." (*Ibid.*)

As the majority points out, the Uniform Standards Act does not apply retroactively. (See maj. opn., *ante*, at p. 11, fn. 12.) That does not end the preemption inquiry, however. Given the several actual, irresolvable conflicts between the Reform Act and California's Blue Sky Law, the federal statute itself *impliedly* preempts the state law on which this suit rests. The reason is as well established as it is simple – California's Act, as the court now interprets it, " '[stands] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.' " (*Barnett Bank of Marion Cty., N.A. v. Nelson* (1996) 517 U.S. 25, 31 [116 S.Ct. 1103, 1108] (*Barnett Bank*), quoting *Hines v. Davidowitz* (1941) 312 U.S. 52, 67; see also *Freightliner Corp. v. Myrick* (1995) 514 U.S. 280, 287 [115 S.Ct. 1483, 1487] ["a federal statute implicitly overrides state law . . . when state law is in actual conflict with federal law"]; *Florida Avocado Growers v. Paul* (1963) 373 U.S. 132, 141.)

It is a bedrock proposition of supremacy clause jurisprudence that where federal and state laws are in "irreconcilable conflict," state law must give way. (*Rice v. Norman Williams Co.* (1982) 458 U.S. 654, 659.) That much was established early on by Chief Justice Marshall's opinion in *Gibbons v. Ogden* (1824) 22 U.S. (9 Wheat) 1, 210-211 (The supremacy clause applies "to such acts of the state legislatures as . . . *interfere* with, or are contrary to, the laws of congress. . . . [I]n every such case, the act of

congress . . . is supreme; and the law of the state . . . must yield to it." [Italics added.]). That is plainly the case here.

Recent decisions by several state appellate courts applying these established "implied conflict preemption" principles in analogous securities fraud class action cases strongly suggest (if they do not establish unequivocally) that this suit, too, is in "direct and irreconcilable conflict" with the federal Reform Act. It is thus preempted. In *Guice v. Charles Schwab & Co., Inc.* (1996) 89 N.Y.2d 31, certiorari denied 117 S.Ct. 1250 (*Guice*), retail securities customers of two nationwide discount stock brokerage firms sought national class action monetary and injunctive relief, claiming that the failure of defendant brokers to disclose the acceptance of "payments for order flow" from wholesale securities dealers for routing customer orders to them breached defendants' fiduciary obligation under New York's common law of agency of "full and frank disclosure" to plaintiffs. (*Id.* at p. 38.)

Relying on *Barnett Bank, supra*, 517 U.S. 25 [116 S.Ct. 1103], the latest in a long line of Supreme Court implied preemption decisions, the New York Court of Appeals held the claims of the plaintiff class were preempted by the 1975 amendments to the Securities Exchange Act and the implementing Securities Exchange Commission (SEC) regulations. (*Guice, supra*, 89 N.Y.2d at p. 39.) The amendments, the New York high court reasoned, "were intended to give the SEC the power administratively to develop a 'coherent and rational regulatory structure to correspond to and to police effectively the new national [securities] market system [citation].' " (*Id.* at pp. 45-46.) If the courts of each of the 50 states were permitted "to impose civil liability on national securities brokerage

firms . . . for failure to meet more stringent common-law agency standards of disclosure of receipt of order flow payments (rather than the Federally mandated *uniform* specific disclosure . . .)[,] the congressional purpose of enabling the SEC to develop and police [a] 'coherent regulatory structure' for a national market system" would be defeated. (*Id.* at p. 46.)

The *Guice* decision does not stand alone. Fully a half-dozen opinions by appellate courts across the country have reached the identical conclusion. (See *Dahl v. Charles Schwab & Co., Inc.* (Minn. 1996) 545 N.W.2d 918, 925, cert. den. 117 S.Ct. 176 [reasoning that compliance with state laws might lead to an end to the practice of order flow payments, thus conflicting with federal law permitting it; state law preempted]; *Eirman v. Olde Discount Corp.* (Fla.Dist.Ct.App. 1997) 697 So.2d 865 [adopting rationale of *Guice* and *Dahl*]; *Orman v. Charles Schwab & Co., Inc.* (Ill. 1997) 688 N.E.2d 620, cert. den. 118 S.Ct. 1518 [maintenance of state claims by plaintiff class would obstruct the national market system Congress intended to foster; state law preempted]; *McKey v. Charles Schwab & Co.* (1998) 67 Cal.App.4th 731 (*McKey*) [collecting the cases nationally and adopting the rationale of *Guice* and *Dahl*].) To our knowledge, the only contrary authority consists of two federal district court decisions, one of which is unreported. (See *Gilman v. Wheat, First Securities, Inc.* (D.Md. 1995) 896 F.Supp. 507; *Thomas v. Charles Schwab & Co., Inc.* (W.D.La. July 12, 1995, No. 95-0307) 1995 WL 626522; cf. *McKey, supra,* at pp. 740-741.)

Many of the factors that determined the result in the *Guice* and *Dahl* cases are present in this case. It is clear from the legislative history of the Reform Act (see Reform

Act Report, *supra*, at pp. 683-703) that Congress was motivated by what the Senate report called "frivolous 'strike' suits alleging violations of the Federal securities laws in the hope that defendants will quickly settle to avoid the expense of litigation. These suits, which unnecessarily increase the cost of raising capital and chill corporate disclosure, are often based on nothing more than a company's announcement of bad news, not evidence of fraud." (*Id.* at p. 683.) Virtually the entire thrust of the Reform Act is directed at inhibiting such "strike" shareholder litigation, which typically takes the form of fraud-based class action suits brought under SEC rule 10(b)-5 (17 C.F.R. § 240.10b-5).

The Reform Act adopts a number of measures intended by Congress to remove incentives to shareholder participation in what the Reform Act's managers called class action litigation "abuses." (Reform Act Report, *supra*, at p. 683.) These include a "safe harbor" or circumscribed immunity from liability provision for "forward-looking statements" or forecasts by issuers if prescribed conditions are met (Reform Act, *supra*, § 102(a)); a mandatory stay of discovery in federal court litigation while a motion to dismiss is pending; enhanced pleading standards that require fact-specific recitals of allegations supporting fraud claims; a "lead plaintiff" provision designed to put shareholders, rather than class counsel, in charge of securities class action litigation; and a system of proportionate, rather than joint and several, liability for defendants not shown to have committed fraud knowingly. (*Id.*, § 101(b).)

Consider only one of the several possible conflicts with the California securities statute these provisions

might produce: If, on the one hand, the federal Reform Act *limits* the liability of securities issuers for "forward looking" forecasts when the conditions prescribed by the "safe harbor" requirements (15 U.S.C. § 78u-5 of the Securities Exchange Act of 1934) are present and, on the other hand, California's Blue Sky Law imposes an *unqualified* liability on securities issuers for such forecasts, the two provisions cannot be reconciled. Because it is impossible for those subject to the California statute and the Reform Act to comply with both, the state statute must give way.

Indeed, not a single provision of the Reform Act has a counterpart in California's Act. That fact probably accounts for the "migration," in the wake of passage of the Reform Act, of securities fraud class action litigation from the federal courts, historically the overwhelmingly preferred venue, to the suddenly more hospitable state courts and state blue sky statutes. An analysis prepared by Stanford Law School's Securities Litigation Law Project found that although the aggregate number of securities fraud class action lawsuits remained relatively static following enactment of the Reform Act, that statistic masks an underlying and significant change – a sharp increase in securities fraud class action litigation brought under state Blue Sky Law, and a corresponding diminution in comparable federal court SEC-based litigation. (Grundfest & Perino, *Securities Litigation Reform: The First Year's Experience* (Feb. 27, 1997) <http://securities.stanford.edu/report/pslra_yrl/index.html (Grundfest & Perino).)

According to the authors of the Stanford study, the migratory trend from federal to state courts is driven by

efforts of the plaintiffs' securities class action bar to evade the litigation hurdles the Reform Act placed in the path of such suits. The evidence presented, the study's authors concluded, "suggests that the level of class action securities fraud litigation has declined by about a third in federal courts, but that there has been an almost equal increase in the level of state court activity, largely as a result of the 'substitution effect' whereby plaintiffs resort to state court to avoid the new, more stringent requirements of federal cases." (Grundfest & Perino, *supra*, at XI. Conclusions and Policy Issues.)

Under California law, nothing comparable to the provisions of the Reform Act – intended both to make abusive securities strike litigation more difficult to mount and sustain, and to further the declared congressional policy of a national securities market – would apply to class action securities fraud suits filed in our courts. Blue sky suits can thus continue to be financed and controlled by the same handful of class counsel whose "appearance ratio" has climbed significantly since passage of the Reform Act. (Grundfest & Perino, *supra*, at VII. Appearance Ratio of Plaintiff Law Firms.) The Reform Act's mandatory freeze on discovery imposed by the Uniform Standards Act would not apply to state blue sky suits either. Indeed, class counsel's use of state blue sky statutes as a device to evade the Reform Act's provisions has already been documented. Observers point to the increasingly common practice of filing parallel securities fraud class action suits – one in state court, another in federal court – as a means of evading the Reform Act's mandatory discovery stay. (See, e.g., Grundfest & Perino, *supra*, at XI. Conclusions and Policy Issues ["There has also

been an increase in parallel litigation between state and federal courts in an apparent effort to avoid the federal discovery stay or other provisions of the Reform Act."].) Just that kind of whipsaw evasion was apparently attempted in this case. (See *In re Diamond Multimedia Systems, Inc. Securities Litigation* (N.D. Cal., 1996, No. C-96-2644-SBA).) The same conflict would seem to hold true for the Reform Act's enhanced, fact-specific pleading requirements and proportionate liability standard.

Although inferential, the conclusion is inescapable: if state courts resolutely ignore implied preemption principles, the effect of Congress's passage of the Reform Act will be to offer securities plaintiffs and their class counsel a "safe harbor" from which to evade the effects of the Reform Act. And that is exactly what has happened. Congress is now aware of the trend toward circumventing the Reform Act's impediments to securities class action litigation by migrating to state courts as the forum of choice. Indeed, Congress has acted with unusual speed to pass legislation precluding state court forum-shopping by securities class action counsel. The Uniform Standards Act *expressly* preempts state laws in conflict with the standards prescribed by the Reform Act.

The effect of the uniform standards legislation, however, is itself "forward looking." The question thus becomes whether a small population of securities issuers, cut off from the express effects of the Uniform Standards Act, has been marooned: deprived of the benefits of Congress's dual policy of furthering a national securities market while deterring abusive securities class action litigation. In other words, the relevant inquiry now is not,

as plaintiffs argue, whether California's Act applies to extrastate transactions. Congress has *expressly* preempted state securities laws as of November 1998 with the enactment of the Uniform Standards Act. Before that date, however, Congress had *impliedly* preempted state blue sky provisions, including California's, that are in "irreconcilable conflict" with the provisions of the Reform Act itself.

The similarities between the case before the New York Court of Appeals in *Guice, supra*, 89 N.Y.2d 31, and this case are not only compelling, they point to the same conclusion. Just as the 1975 amendments to the Securities Exchange Act "were intended to give the SEC the power administratively to develop a 'coherent and rational regulatory structure to correspond to and to police effectively the new national [securities] market system' [citation]," so, 20 years later, the provisions of the Reform Act were intended by Congress to continue the development of that same national securities market. (89 N.Y.2d at pp. 45-46.) And just as the New York Court of Appeals reasoned that permitting the courts of each of the 50 states "to impose civil liability on national securities brokerage firms . . . for failure to meet more stringent [state] . . . standards" (*id.* at p. 46) would defeat Congress's "purpose of enabling the SEC to develop and police [a] 'coherent regulatory structure' for a national market system," (*ibid.*) so fragmentation of the Reform Act's express national standard into as many as 50 different state standards would wreak havoc on federal efforts to protect that market from abusive litigation practices.

As the United States Supreme Court said in rejecting a comparable scenario involving nuisance abatement

suits under state law and the federal Clean Water Act, "It is unlikely – to say the least – that Congress intended to establish such a chaotic regulatory structure." (*International Paper Co. v. Ouellette* (1987) 479 U.S. 481, 497.) The prospect of regulatory chaos raised by the *Ouellette* case, a prospect that would result from the efforts of one state to "do indirectly what [it] could not do directly – regulate the conduct of out-of-state [pollution] sources" (*id.* at p. 495) – suggests that application of California's Blue Sky statutes in this case would also violate the commerce clause of the federal Constitution. (U.S. Const., art. I, § 8.)

The court's reasoning in *Edgar v. MITE Corp.* (1982) 457 U.S. 624 (*Edgar*) explains why. A newly enacted Illinois antitakeover statute imposed a 20-day freeze on tender offers for shares of certain target companies (defined in terms of the target's contacts with Illinois residents). Because it favored target defenses, the 20-day freeze conflicted with the federal Williams Act (amending the Securities Exchange Act of 1934), which had no freeze period, and with Congress's declared policy of neutrality in takeover battles. In addition, provisions of the Williams Act laid down detailed rules intended to protect the interests of shareholders without "tipping the scales" in favor of the takeover company or its target. (*Edgar, supra,* 457 U.S. at p. 633.)

The court found that three provisions of the state antitakeover statute "upset the careful balance struck by Congress [in the Williams Act] and that therefore stand as obstacles to the accomplishment . . . of the full purposes and objectives of Congress." (*Edgar, supra,* 457 U.S. at p. 634.) Although states are free to regulate intrastate securities transactions, blue sky statutes that have "a

direct restraint on interstate commerce and . . . a sweeping extraterritorial effect" are void under the commerce clause. (*Id.* at p. 642.) The court in *Edgar* went on to say that "the State has no legitimate interest in protecting nonresident shareholders" (*id.* at p. 644) and that provisions of the Williams Act also duplicated substantive protection for shareholders provided in the state statute. (*Ibid.*) Because the Illinois statute "imposes a substantial burden on interstate commerce which outweighs its putative local benefits," it was invalid under the commerce clause. (*Id.* at p. 646.)

The same considerations that led the court to declare the Illinois statute at issue in *Edgar, supra,* 457 U.S. 624, unconstitutional under the commerce clause apply here. And they point to the same result. As the opinion in *Edgar* observed, "[t]he Court's rationale for upholding blue-sky laws was that they only regulated transactions occurring within the regulating States." (*Id.* at p. 641.) The commerce clause, however, "precludes the application of a state statute to commerce that takes place *wholly outside of the State's borders,* whether or not the commerce has effects within the State." (*Id.* at pp. 642-643, italics added.) Like the constitutional limitations on a state's assertion of extraterritorial jurisdiction, "[i]n either case, 'any attempt "directly" to assert extraterritorial jurisdiction over persons or property would offend sister States and exceed the inherent limits of the State's power.' " (*Id.* at p. 643, quoting *Shaffer v. Heitner* (1977) 433 U.S. 186, 197.)

Conclusion

The majority's decision is at odds with the text and structure of the Act and a quarter-century's understanding that it does not extend beyond California's borders. Fearful, perhaps, that state courts would not give effect to an implicit intent by applying established preemption rules, less than two months ago Congress acted to *expressly* rule out application of conflicting state blue sky laws. For these defendants, congressional action comes too late. Cut off from the Uniform Standards Act, stranded by today's ruling, these unlucky few are left to fend for themselves. The concrete unfairness of that result is palpable enough; it is only heightened by this court's determination to ignore well-established principles governing implied preemption even in the face of the near unanimity among courts across the country in holding that similar 1975 amendments to the Securities Exchange Act preempted state laws in conflict with Congress's intent.

I dissent.

BROWN, J.

I CONCUR:

CHIN, J.

APPENDIX B

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA SIXTH APPELLATE DISTRICT

DIAMOND MULTIMEDIA, INC., et al.,
Petitioners,

vs.

THE SUPERIOR COURT OF SANTA CLARA COUNTY,
Respondent;

JOANNE PASS, et al.,
Real Parties in Interest.
_____/

No. H016376
Super. Ct. No. CV758927

(Filed Jan. 17, 1997)

BY THE COURT

The petition for writ of mandate and request for an immediate stay is denied. (Elia, Acting P.J., and Mihara, J., participated in this decision.)

Dated JAN 17 1997

ELIA, J. Acting P.J.

APPENDIX C

IN THE SUPERIOR COURT OF THE STATE OF CALIFORNIA IN AND FOR THE COUNTY OF SANTA CLARA

JOANNE PASS, On Behalf of Herself and All Others Similarly Situated, Plaintiff, vs. HYUNG HWE HUH, WILLIAM J. SCHROEDER, GARY B. FILLER, CHONG-MOON LEE, and DIAMOND MULTIMEDIA SYSTEMS, INC., Defendants.	Case No. CV-758927, CV-759012 and CV-759270 ORDER (Filed Dec. 26, 1996)

The above matter was heard on December 12, 1996, in Dept. 17 before the Honorable Peter G. Stone.

I. Demurrer and Motion to Strike of Defendants Schroeder, Filler, Huh and Diamond

The demurrer of the Diamond Defendants to the First cause of action for violations of Corporation Code §§ 25400 and 25500 is overruled.

In addition, Plaintiffs adequately alleged that the individual Defendants made misstatements for the purpose of inducing the purchase of their Diamond stock.

The individual Defendants are not liable under Corporation Code § 25400 for aiding/abetting or conspiracy. Corporation Code §§ 25400 and 25500 provide a remedy for fraud in connection with after market transactions. Diamond may be held liable for statements that were not made in connection with the November 1995 stock offering.

The demurrer of the Diamond Defendants to the Second cause of action for violations of Civil Code §§ 1709 and 1710 is sustained with leave to amend. Plaintiffs have failed to adequately allege actual reliance (*Mirkin vs. Wasserman* (1993) 5 Cal.4th 1082).

The requests for judicial notice of the Diamond Defendants is granted. The motion to strike of the Diamond Defendants is MOOT.

II. Demurrer and Motion to Strike of Defendant Lee

The special demurrer of Defendant Lee for uncertainty is overruled (*Khoury vs. Maly's of California, Inc.* (1993) 14 Cal.App.4th 612). Defendant Lee can reasonably determine what issues must be admitted or denied. Defendant Lee can also reasonably determine what counts or claims are directed against him.

The demurrer of Defendant Lee on the grounds of particularity is sustained with leave to amend (*Fisher vs. San Pedro Peninsula Hospital,* 214 Cal. App.3d (1989) 590; *Committee on Children's Television, Inc. vs. General Foods Corporation* (1983) 35 Cal.3d 197). Plaintiffs are required to

plead with more particularity the specific false or misleading statements or omissions in which Defendant Lee allegedly participated.

The demurrer of Defendant Lee on the grounds of impermissible standard of pleading is sustained with leave to amend. Plaintiffs are required to allege facts based on information and belief.

In addition, Plaintiffs have not properly alleged any secondary Liability of Defendant Lee under Corporation Code § 25400. Defendant Lee is not liable under Corporation Code § 25400 for aiding/abetting or conspiracy.

The motion to strike of Defendant Lee is MOOT.

Dated: Dec. 26, 1996.

/s/ Peter G. Stone
PETER G. STONE
Judge of the Superior Court

APPENDIX D

California Corporations Code § 25400. Unlawful acts or misrepresentations to induce purchase or sale of securities or to manipulate price

It is unlawful for any person, directly or indirectly, in this state:

(a) For the purpose of creating a false or misleading appearance of active trading in any security or a false or misleading appearance with respect to the market for any security, (1) to effect any transaction in a security which involves no change in the beneficial ownership thereof, or (2) to enter an order or orders for the purchase of any security with the knowledge that an order or orders of substantially the same size, at substantially the same time and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or (3) to enter an order or orders for the sale of any security with the knowledge that an order or orders of substantially the same size, at substantially the same time and at substantially the same price, for the purchase of any such security, has been or will be entered by or for the same or different parties.

(b) To effect, alone or with one or more other persons, a series of transactions in any security creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

(c) If such person is a broker-dealer or other person selling or offering for sale or purchasing or offering to

purchase the security, to induce the purchase or sale of any security by the circulation or dissemination of information to the effect that the price of any such security will or is likely to rise or fall because of market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

(d) If such person is a broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security, to make, for the purpose of inducing the purchase or sale of such security by others, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or which omitted to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and which he knew or had reasonable ground to believe was so false or misleading.

(e) For a consideration, received directly or indirectly from a broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security, to induce the purchase or sale of any security by the circulation or dissemination of information to the effect that the price of such security will or is likely to rise or fall because of the market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

APPENDIX E

California Corporations Code § 25500. Participation in acts, or transactions in violation of section 25400; damages

Any person who willfully participates in any act or transaction in violation of Section 25400 shall be liable to any other person who purchases or sells any security at a price which was affected by such act or transaction for the damages sustained by the latter as a result of such act or transaction. Such damages shall be the difference between the price at which such other person purchased or sold securities and the market value which such securities would have had at the time of his purchase or sale in the absence of such act or transaction, plus interest at the legal rate.

APPENDIX F

15 U.S.C. § 78u-4. Private securities litigation

(a) Private class actions

(1) In general

The provisions of this subsection shall apply in each private action arising under this chapter that is brought as a plaintiff class action pursuant to the Federal Rules of Civil Procedure.

(2) Certification filed with complaint

(A) In general

Each plaintiff seeking to serve as a representative party on behalf of a class shall provide a sworn certification, which shall be personally signed by such plaintiff and filed with the complaint, that –

(i) states that the plaintiff has reviewed the complaint and authorized its filing;

(ii) states that the plaintiff did not purchase the security that is the subject of the complaint at the direction of plaintiff's counsel or in order to participate in any private action arising under this chapter;

(iii) states that the plaintiff is willing to serve as a representative party on behalf of a class, including providing testimony at deposition and trial, if necessary;

(iv) sets forth all of the transactions of the plaintiff in the security that is the subject of the complaint during the class period specified in the complaint;

(v) identifies any other action under this chapter, filed during the 3-year period preceding the date on which the certification is signed by the plaintiff, in which the plaintiff has sought to serve as a representative party on behalf of a class; and

(vi) states that the plaintiff will not accept any payment for serving as a representative party on behalf of a class beyond the plaintiff's pro rata share of any recovery, except as ordered or approved by the court in accordance with paragraph (4).

(B) Nonwaiver of attorney-client privilege

The certification filed pursuant to subparagraph (A) shall not be construed to be a waiver of the attorney-client privilege.

(3) Appointment of lead plaintiff

(A) Early notice to class members

(i) In general

Not later than 20 days after the date on which the complaint is filed, the plaintiff or plaintiffs shall cause to be published, in a widely circulated national business-oriented publication or wire service, a notice advising members of the purported plaintiff class –

(I) of the pendency of the action, the claims asserted therein, and the purported class period; and

(II) that, not later than 60 days after the date on which the notice is published, any member of the purported class may move the court to

serve as lead plaintiff of the purported class.

(ii) Multiple actions

If more than one action on behalf of a class asserting substantially the same claim or claims arising under this chapter is filed, only the plaintiff or plaintiffs in the first filed action shall be required to cause notice to be published in accordance with clause (i).

(iii) Additional notices may be required under Federal rules

Notice required under clause (i) shall be in addition to any notice required pursuant to the Federal Rules of Civil Procedure.

(B) Appointment of lead plaintiff

(i) In general

Not later than 90 days after the date on which a notice is published under subparagraph (A)(i), the court shall consider any motion made by a purported class member in response to the notice, including any motion by a class member who is not individually named as a plaintiff in the complaint or complaints, and shall appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members (hereafter in this paragraph referred to as the "most adequate plaintiff") in accordance with this subparagraph.

(ii) Consolidated actions

If more than one action on behalf of a class asserting substantially the same claim or claims arising under this chapter has been filed, and any party has sought to consolidate those actions for pretrial purposes or for trial, the court shall not make the determination required by clause (i) until after the decision on the motion to consolidate is rendered. As soon as practicable after such decision is rendered, the court shall appoint the most adequate plaintiff as lead plaintiff for the consolidated actions in accordance with this paragraph.

(iii) Rebuttable presumption

(I) In general

Subject to subclause (II), for purposes of clause (i), the court shall adopt a presumption that the most adequate plaintiff in any private action arising under this chapter is the person or group of persons that –

(aa) has either filed the complaint or made a motion in response to a notice under subparagraph (A)(i);

(bb) in the determination of the court, has the largest financial interest in the relief sought by the class; and

(cc) otherwise satisfies the requirements of Rule 23 of the

Federal Rules of Civil Procedure.

(II) Rebuttal evidence

The presumption described in subclause (I) may be rebutted only upon proof by a member of the purported plaintiff class that the presumptively most adequate plaintiff –

(aa) will not fairly and adequately protect the interests of the class; or

(bb) is subject to unique defenses that render such plaintiff incapable of adequately representing the class.

(iv) Discovery

For purposes of this subparagraph, discovery relating to whether a member or members of the purported plaintiff class is the most adequate plaintiff may be conducted by a plaintiff only if the plaintiff first demonstrates a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class.

(v) Selection of lead counsel

The most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class.

(vi) Restrictions on professional plaintiffs

Except as the court may otherwise permit, consistent with the purposes of this

section, a person may be a lead plaintiff, or an officer, director, or fiduciary of a lead plaintiff, in no more than 5 securities class actions brought as plaintiff class actions pursuant to the Federal Rules of Civil Procedure during any 3-year period.

(4) Recovery by plaintiffs

The share of any final judgment or of any settlement that is awarded to a representative party serving on behalf of a class shall be equal, on a per share basis, to the portion of the final judgment or settlement awarded to all other members of the class. Nothing in this paragraph shall be construed to limit the award of reasonable costs and expenses (including lost wages) directly relating to the representation of the class to any representative party serving on behalf of a class.

(5) Restrictions on settlements under seal

The terms and provisions of any settlement agreement of a class action shall not be filed under seal, except that on motion of any party to the settlement, the court may order filing under seal for those portions of a settlement agreement as to which good cause is shown for such filing under seal. For purposes of this paragraph, good cause shall exist only if publication of a term or provision of a settlement agreement would cause direct and substantial harm to any party.

(6) Restrictions on payment of attorneys' fees and expenses

Total attorneys' fees and expenses awarded by the court to counsel for the plaintiff class shall not exceed a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class.

(7) Disclosure of settlement terms to class members

Any proposed or final settlement agreement that is published or otherwise disseminated to the class shall include each of the following statements, along with a cover page summarizing the information contained in such statements:

(A) Statement of plaintiff recovery

The amount of the settlement proposed to be distributed to the parties to the action, determined in the aggregate and on an average per share basis.

(B) Statement of potential outcome of case

(i) Agreement on amount of damages

If the settling parties agree on the average amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this chapter, a statement concerning the average amount of such potential damages per share.

(ii) Disagreement on amount of damages

If the parties do not agree on the average amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this chapter, a statement from each settling party concerning the issue or issues on which the parties disagree.

(iii) Inadmissibility for certain purposes

A statement made in accordance with clause (i) or (ii) concerning the amount of

damages shall not be admissible in any Federal or State judicial action or administrative proceeding, other than an action or proceeding arising out of such statement.

(C) Statement of attorneys' fees or costs sought

If any of the settling parties or their counsel intend to apply to the court for an award of attorneys' fees or costs from any fund established as part of the settlement, a statement indicating which parties or counsel intend to make such an application, the amount of fees and costs that will be sought (including the amount of such fees and costs determined on an average per share basis), and a brief explanation supporting the fees and costs sought. Such information shall be clearly summarized on the cover page of any notice to a party of any proposed or final settlement agreement.

(D) Identification of lawyers' representatives

The name, telephone number, and address of one or more representatives of counsel for the plaintiff class who will be reasonably available to answer questions from class members concerning any matter contained in any notice of settlement published or otherwise disseminated to the class.

(E) Reasons for settlement

A brief statement explaining the reasons why the parties are proposing the settlement.

(F) Other information

Such other information as may be required by the court.

(8) Security for payment of costs in class actions

In any private action arising under this chapter that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the court may require an undertaking from the attorneys for the plaintiff class, the plaintiff class, or both, or from the attorneys for the defendant, the defendant, or both, in such proportions and at such times as the court determines are just and equitable, for the payment of fees and expenses that may be awarded under this subsection.

(9) Attorney conflict of interest

If a plaintiff class is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation, the court shall make a determination of whether such ownership or other interest constitutes a conflict of interest sufficient to disqualify the attorney from representing the plaintiff class.

(b) Requirements for securities fraud actions

(1) Misleading statements and omissions

In any private action arising under this chapter in which the plaintiff alleges that the defendant –

(A) made an untrue statement of a material fact; or

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the

statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

(2) Required state of mind

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

(3) Motion to dismiss; stay of discovery

(A) Dismissal for failure to meet pleading requirements

In any private action arising under this chapter, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.

(B) Stay of discovery

In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.

(C) Preservation of evidence

(1) In general

During the pendency of any stay of discovery pursuant to this paragraph,

unless otherwise ordered by the court, any party to the action with actual notice of the allegations contained in the complaint shall treat all documents, data compilations (including electronically recorded or stored data), and tangible objects that are in the custody or control of such person and that are relevant to the allegations, as if they were the subject of a continuing request for production of documents from an opposing party under the Federal Rules of Civil Procedure.

(ii) Sanction for willful violation

A party aggrieved by the willful failure of an opposing party to comply with clause (i) may apply to the court for an order awarding appropriate sanctions.

(4) Loss causation

In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

(c) Sanctions for abusive litigation

(1) Mandatory review by court

In any private action arising under this chapter, upon final adjudication of the action, the court shall include in the record specific findings regarding compliance by each party and each attorney representing any party with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion.

(2) Mandatory sanctions

If the court makes a finding under paragraph (1) that a party or attorney violated any requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion, the court shall impose sanctions on such party or attorney in accordance with Rule 11 of the Federal Rules of Civil Procedure. Prior to making a finding that any party or attorney has violated Rule 11 of the Federal Rules of Civil Procedure, the court shall give such party or attorney notice and an opportunity to respond.

(3) Presumption in favor of attorneys' fees and costs

(A) In general

Subject to subparagraphs (B) and (C), for purposes of paragraph (2), the court shall adopt a presumption that the appropriate sanction –

(i) for failure of any responsive pleading or dispositive motion to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred as a direct result of the violation; and

(ii) for substantial failure of any complaint to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred in the action.

(B) Rebuttal evidence

The presumption described in subparagraph (A) may be rebutted only upon proof by

the party or attorney against whom sanctions are to be imposed that –

(i) the award of attorneys' fees and other expenses will impose an unreasonable burden on that party or attorney and would be unjust, and the failure to make such an award would not impose a greater burden on the party in whose favor sanctions are to be imposed; or

(ii) the violation of Rule 11(b) of the Federal Rules of Civil Procedure was de minimis.

(C) Sanctions

If the party or attorney against whom sanctions are to be imposed meets its burden under subparagraph (B), the court shall award the sanctions that the court deems appropriate pursuant to Rule 11 of the Federal Rules of Civil Procedure.

(d) Defendant's right to written interrogatories

In any private action arising under this chapter in which the plaintiff may recover money damages, the court shall, when requested by a defendant, submit to the jury a written interrogatory on the issue of each such defendant's state of mind at the time the alleged violation occurred.

(e) Limitation on damages

(1) In general

Except as provided in paragraph (2), in any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference

between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

(2) Exception

In any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.

(3) Definition

For purposes of this subsection, the "mean trading price" of a security shall be an average of the daily trading price of that security, determined as of the close of the market each day during the 90-day period referred to in paragraph (1).

(g) Proportionate liability

(1) Applicability

Nothing in this subsection shall be construed to create, affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws.

(2) Liability for damages

(A) Joint and several liability

Any covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws.

(B) Proportionate liability

(i) In general

Except as provided in paragraph (1), a covered person against whom a final judgment is entered in a private action shall be liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that covered person, as determined under paragraph (3).

(ii) Recovery by and costs of covered person

In any case in which a contractual relationship permits, a covered person that prevails in any private action may recover the attorney's fees and costs of that covered person in connection with the action.

(3) Determination of responsibility

(A) In general

In any private action, the court shall instruct the jury to answer special interrogatories, or if there is no jury, shall make findings, with respect to each covered person and each of the other persons claimed by any of the parties to have caused or contributed to the loss incurred by the plaintiff, including persons who

have entered into settlements with the plaintiff or plaintiffs, concerning –

(i) whether such person violated the securities laws;

(ii) the percentage of responsibility of such person, measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff; and

(iii) whether such person knowingly committed a violation of the securities laws.

(B) Contents of special interrogatories or findings

The responses to interrogatories, or findings, as appropriate, under subparagraph (A) shall specify the total amount of damages that the plaintiff is entitled to recover and the percentage of responsibility of each covered person found to have caused or contributed to the loss incurred by the plaintiff or plaintiffs.

(C) Factors for consideration

In determining the percentage of responsibility under this paragraph, the trier of fact shall consider –

(i) the nature of the conduct of each covered person found to have caused or contributed to the loss incurred by the plaintiff or plaintiffs; and

(ii) the nature and extent of the causal relationship between the conduct of each such person and the damages incurred by the plaintiff or plaintiffs.

(4) Uncollectible share

(A) In general

Notwithstanding paragraph (2)(B), upon[2] motion made not later than 6 months after a final judgment is entered in any private action, the court determines that all or part of the share of the judgment of the covered person is not collectible against that covered person, and is also not collectible against a covered person described in paragraph (2)(A), each covered person described in paragraph (2)(B) shall be liable for the uncollectible share as follows:

(i) Percentage of net worth

Each covered person shall be jointly and severally liable for the uncollectible share if the plaintiff establishes that –

(I) the plaintiff is an individual whose recoverable damages under the final judgment are equal to more than 10 percent of the net worth of the plaintiff; and

(II) the net worth of the plaintiff is equal to less than $200,000.

(ii) Other plaintiffs

With respect to any plaintiff not described in subclauses (I) and (II) of clause (i), each covered person shall be liable for the uncollectible share in proportion to the percentage of responsibility of that covered person, except that the total liability of a covered person under this clause may

not exceed 50 percent of the proportionate share of that covered person, as determined under paragraph (3)(B).

(iii) Net worth

For purposes of this subparagraph, net worth shall be determined as of the date immediately preceding the date of the purchase or sale (as applicable) by the plaintiff of the security that is the subject of the action, and shall be equal to the fair market value of assets, minus liabilities, including the net value of the investments of the plaintiff in real and personal property (including personal residences).

(B) Overall limit

In no case shall the total payments required pursuant to subparagraph (A) exceed the amount of the uncollectible share.

(C) Covered persons subject to contribution

A covered person against whom judgment is not collectible shall be subject to contribution and to any continuing liability to the plaintiff on the judgment.

(5) Right of contribution

To the extent that a covered person is required to make an additional payment pursuant to paragraph (4), that covered person may recover contribution –

(A) from the covered person originally liable to make the payment;

(B) from any covered person liable jointly and severally pursuant to paragraph (2)(A);

(C) from any covered person held proportionately liable pursuant to this paragraph who is liable to make the same payment and has paid less than his or her proportionate share of that payment; or

(D) from any other person responsible for the conduct giving rise to the payment that would have been liable to make the same payment.

(6) Nondisclosure to jury

The standard for allocation of damages under paragraphs (2) and (3) and the procedure for reallocation of uncollectible shares under paragraph (4) shall not be disclosed to members of the jury.

(7) Settlement discharge

(A) In general

A covered person who settles any private action at any time before final verdict or judgment shall be discharged from all claims for contribution brought by other persons. Upon entry of the settlement by the court, the court shall enter a bar order constituting the final discharge of all obligations to the plaintiff of the settling covered person arising out of the action. The order shall bar all future claims for contribution arising out of the action –

(i) by any person against the settling covered person; and

(ii) by the settling covered person against any person, other than a person whose liability has been extinguished by

the settlement of the settling covered person.

(B) Reduction

If a covered person enters into a settlement with the plaintiff prior to final verdict or judgment, the verdict or judgment shall be reduced by the greater of –

(i) an amount that corresponds to the percentage of responsibility of that covered person; or

(ii) the amount paid to the plaintiff by that covered person.

(8) Contribution

A covered person who becomes jointly and severally liable for damages in any private action may recover contribution from any other person who, if joined in the original action, would have been liable for the same damages. A claim for contribution shall be determined based on the percentage of responsibility of the claimant and of each person against whom a claim for contribution is made.

(9) Statute of limitations for contribution

In any private action determining liability, an action for contribution shall be brought not later than 6 months after the entry of a final, nonappealable judgment in the action, except that an action for contribution brought by a covered person who was required to make an additional payment pursuant to paragraph (4) may be brought not later than 6 months after the date on which such payment was made.

(10) Definitions

For purposes of this subsection –

(A) a covered person "knowingly commits a violation of the securities laws" –

(i) with respect to an action that is based on an untrue statement of material fact or omission of a material fact necessary to make the statement not misleading, if –

(I) that covered person makes an untrue statement of a material fact, with actual knowledge that the representation is false, or omits to state a fact necessary in order to make the statement made not misleading, with actual knowledge that, as a result of the omission, one of the material representations of the covered person is false; and

(II) persons are likely to reasonably rely on that misrepresentation or omission; and

(ii) with respect to an action that is based on any conduct that is not described in clause (i), if that covered person engages in that conduct with actual knowledge of the facts and circumstances that make the conduct of that covered person a violation of the securities laws;

(B) reckless conduct by a covered person shall not be construed to constitute a knowing commission of a violation of the securities laws by that covered person;

(C) the term "covered person" means –

(i) a defendant in any private action arising under this chapter; or

(ii) a defendant in any private action arising under section 77k of this title, who is an outside director of the issuer of the securities that are the subject of the action; and

(D) the term "outside director" shall have the meaning given such term by rule or regulation of the Commission.

APPENDIX G

15 U.S.C. § 78u-5. Application of safe harbor for forward-looking statements

(a) Applicability. This section shall apply only to a forward-looking statement made by –

(1) an issuer that, at the time that the statement is made, is subject to the reporting requirements of section 13(a) or section 15(d) [*15 USCS § 78m*(a) or 78o(d)];

(2) a person acting on behalf of such issuer;

(3) an outside reviewer retained by such issuer making a statement on behalf of such issuer; or

(4) an underwriter, with respect to information provided by such issuer or information derived from information provided by such issuer.

(b) Exclusions. Except to the extent otherwise specifically provided by rule, regulation, or order of the Commission, this section shall not apply to a forward-looking statement –

(1) that is made with respect to the business or operations of the issuer, if the issuer –

(A) during the 3-year period preceding the date on which the statement was first made –

(i) was convicted of any felony or misdemeanor described in clauses (i) through (iv) of section 15(b)(4)(B) [*15 USCS § 78o*(d)(i)-(iv)]; or

(ii) has been made the subject of a judicial or administrative decree or order arising out of a governmental action that –

(I) prohibits future violations of the anti-fraud provisions of the securities laws;

(II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or

(III) determines that the issuer violated the antifraud provisions of the securities laws;

(B) makes the forward-looking statement in connection with an offering of securities by a blank check company;

(C) issues penny stock;

(D) makes the forward-looking statement in connection with a rollup transaction; or

(E) makes the forward-looking statement in connection with a going private transaction; or

(2) that is –

(A) included in a financial statement prepared in accordance with generally accepted accounting principles;

(B) contained in a registration statement of, or otherwise issued by, an investment company;

(C) made in connection with a tender offer;

(D) made in connection with an initial public offering;

(E) made in connection with an offering by, or relating to the operations of, a partnership, limited liability company, or a direct participation investment program; or

(F) made in a disclosure of beneficial ownership in a report required to be filed with the Commission pursuant to section 13(d) [*15 USCS § 78m*(d)].

(c) Safe harbor.

(1) In general. Except as provided in subsection (b), in any private action arising under this title [*15 USCS §§ 78a* et seq.] that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that –

(A) the forward-looking statement is –

(i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or

(ii) immaterial; or

(B) the plaintiff fails to prove that the forward-looking statement –

(i) if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or

(ii) if made by a business entity; was –

(I) made by or with the approval of an executive officer of that entity; and

(II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading.

(2) Oral forward-looking statements. In the case of an oral forward-looking statement made by an issuer that is subject to the reporting requirements of section 13(a) or section 15(d) [*15 USCS § 78m*(a) or 78o(d)], or by a person acting on behalf of such issuer, the requirement set forth in paragraph (1)(A) shall be deemed to be satisfied –

(A) if the oral forward-looking statement is accompanied by a cautionary statement –

(i) that the particular oral statement is a forward-looking statement; and

(ii) that the actual results might differ materially from those projected in the forward-looking statement; and

(B) if –

(i) the oral forward-looking statement is accompanied by an oral statement that additional information concerning factors that could cause actual results to materially differ from those in the forward-looking statement is contained in a readily available written document, or portion thereof;

(ii) the accompanying oral statement referred to in clause (i) identifies the document, or portion thereof, that contains the additional information about those factors relating to the forward-looking statement; and

(iii) the information contained in that written document is a cautionary statement that satisfies the standard established in paragraph (1)(A).

(3) Availability. Any document filed with the Commission or generally disseminated shall be deemed to be readily available for purposes of paragraph (2).

(4) Effect on other safe harbors. The exemption provided for in paragraph (1) shall be in addition to any exemption that the Commission may establish by rule or regulation under subsection (g).

(d) Duty to update. Nothing in this section shall impose upon any person a duty to update a forward-looking statement.

(e) Dispositive motion. On any motion to dismiss based upon subsection (c)(1), the court shall consider any statement cited in the complaint and any cautionary statement accompanying the forward-looking statement, which are not subject to material dispute, cited by the defendant.

(f) Stay pending decision on motion. In any private action arising under this title [*15 USCS §§ 78a* et seq.], the court shall stay discovery (other than discovery that is specifically directed to the applicability of the exemption provided for in this section) during the pendency of any motion by a defendant for summary judgment that is based on the grounds that –

(1) the statement or omission upon which the complaint is based is a forward-looking statement within the meaning of this section; and

(2) the exemption provided for in this section precludes a claim for relief.

(g) Exemption authority. In addition to the exemptions provided for in this section, the Commission may, by rule or regulation, provide exemptions from or under any provision of this title [*15 USCS §§ 78a* et seq.], including with respect to liability that is based on a statement or that is based on projections or other forward-looking information, if and to the extent that any such exemption is consistent with the public interest and the protection of investors, as determined by the Commission.

(h) Effect on other authority of Commission. Nothing in this section limits, either expressly or by implication, the authority of the Commission to exercise similar authority or to adopt similar rules and regulations with respect to forward-looking statements under any other statute under which the Commission exercises rulemaking authority.

(i) Definitions. For purposes of this section, the following definitions shall apply:

(1) Forward-looking statement. The term "forward-looking statement" means –

(A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;

(B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;

(C) a statement of future economic performance, including any such statement contained in a

discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission;

(D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C);

(E) any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or

(F) a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the Commission.

(2) Investment company. The term "investment company" has the same meaning as in section 3(a) of the Investment Company Act of 1940 [*15 USCS § 80a-3*(a)].

(3) Going private transaction. The term "going private transaction" has the meaning given that term under the rules or regulations of the commission issued pursuant to section 13(e) [*15 USCS § 78m*(e)].

(4) Person acting on behalf of an issuer. The term "person acting on behalf of an issuer" means any officer, director, or employee of such issuer.

(5) Other terms. The terms "blank check company", "rollup transaction", "partnership", "limited liability company", "executive officer of an entity" and "direct participation investment program", have the meanings given those terms by rule or regulation of the Commission.